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THE LETTERS OF AN
INVESTMENT COUNSEL
to Mr. and Mrs. John Smith

THE LETTERS OF AN INVESTMENT COUNSEL to Mr. and Mrs. John Smith

by

H. G. CARPENTER

of E. W. Axe & Co., Inc., Investment Counsel

*Author of "A Successful Investor's
Letters to His Son"*



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THE LETTERS OF AN INVESTMENT COUNSEL
to Mr. and Mrs. John Smith

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To my associates in the
E. W. Axe & Co. organization, who are
engaged to the best of their abilities in
carrying into actual practice the research
and investment policies we have discussed
and studied together

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PREFACE

WITH the first printing of *A Successful Investor's Letters to His Son*, back in 1934, I announced my intention of writing another book, to be entitled *A Successful Investor's Letters to His Wife*. The months and years have slipped by. Every time I began the "letters to my wife" I found myself in trouble. Something was not just right. I could not make the "letters to my wife" say what I wanted to convey to American investors, large and small. Only recently the solution has come to me. My "trouble" was that, by addressing the letters to "my wife," I was restricting myself to the investment problems of a particular woman—a woman representative of only *one class* of American investors. Furthermore, the investment problems of a woman, as a rule, are so inextricably bound up with those of her husband that it is practically impossible to treat the subject satisfactorily without addressing both of them.

I want this book to be helpful to all classes of investors—aggressive and conservative, men and women, married or unmarried, of substantial wealth or of moderate means. The method I have used will permit of such a result, I feel confident. Mr. and Mrs. "John Smith" are people of substantial means. The husband's circumstances, objectives and preferences warrant a somewhat aggressive investment policy, while those of his wife demand more conservative treatment. The investment accounts of certain of their relatives and friends

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show how investment policies must be altered to suit the circumstances, objectives and preferences of different classes of investors, while the cases of still others, with moderate amounts of capital, are illustrative of the problems of the hundreds of thousands of American investors in similar circumstances.

Many of the "letters" are almost exact copies of letters actually written to investment counsel clients who have been served by the organization with which I am associated.

If I may be permitted a suggestion to the reader, it is that he should *not* select one "letter" which seems to apply to his circumstances and expect to derive benefit from it. *The whole book should be read.* I have purposely made it short and non-technical, limiting discussion largely to:

1. Important investment principles
2. The selection of competent investment advisers
3. Major investment misconceptions
4. The treatment of seven classes of investment accounts by investment counsel.

There is also one "letter" on estate planning and another on testamentary trusts which I believe will be helpful to those with estates or trusts to plan or administer.

In the writing of *The Letters of an Investment Counsel to Mr. and Mrs. John Smith* I have been particularly fortunate in having the advice of the heads of the company with which I am affiliated, Emerson Wirt Axe and Ruth Houghton Axe. They have been patient to a remarkable degree and helpful

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in every way, particularly in affording statistical information and in editing manuscript.

New York City

H. G. CARPENTER

Series I

THE MAJOR PROBLEMS OF
INVESTMENT MANAGEMENT

Letter No. 1 . . .

THE THREE TYPES OF SECURITIES AND THEIR RELATION TO THE THREE INVESTMENT OBJECTIVES

DEAR MR. SMITH:

This will acknowledge receipt of your letter of the fifteenth in which you ask for our comments on your list of investments. You have told us little about your circumstances, objectives and preferences, but from what you have said it would seem to us that, first of all, you do not have as clear an understanding as you might of the three *types of securities* and their relation to the three *investment objectives*. I shall therefore devote this letter largely to that subject.

Were Mrs. Smith to ask you to bake a cake, you would in the first place have only a hazy conception of the ingredients to be used. She might tell you: "Flour, milk, eggs, butter, sugar and baking powder," but without information as to the relative quantities of these ingredients, as well as directions regarding the baking, you would probably produce a sad result.

While cake baking is not considered a difficult feat, and while successful investment management, on the other hand, is generally admitted by those who have tried it to be one of life's most difficult achievements, it is surprising to find that many investors, and some substantial ones too, have never catalogued the "ingredients" of investment management—the three *types of securities*.

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“What do you mean by ‘types of securities’?” is a question asked by scores of investors with whom I have talked. I need but hear that question to know, regardless of their age, sex or degree of wealth, that they are not successful investment managers. They can’t be—any more than I can be a good cake baker without knowing what the ingredients of a cake are.

THE THREE TYPES OF SECURITIES

The “ingredients” of investment management—the three *types* of securities—which the successful manager employs to achieve different objectives are:

1. High-grade, short-term bonds and other cash equivalents (such as commercial paper, cash in bank, etc.)
2. High-grade, long-term bonds and very high-grade preferred stocks, and
3. “Earnings-dependent securities”—common stocks, and bonds and preferred stocks not of highest grade, i.e., securities whose prices are directly dependent upon earnings.

Note that we place “bonds and preferred stocks not of highest grade” in the same classification as common stocks. A frequent error on the part of investors is to divide their lists between “bonds” and “stocks” without considering the grade of the bonds. A second- or third-grade bond can, and frequently does fluctuate just as widely as do common stocks. It is for that reason that

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we classify both "common stocks" and "bonds and preferred stocks not of highest grade" as "earnings-dependent securities."

Things often come by threes in investment management. The three general *types of securities* listed above, as we have seen, are the "ingredients" which the successful investment manager employs. They must be used, however, in varying proportions at different times, depending on general economic or business conditions, *to produce the three investment objectives*—safety, income and appreciation—in proportions suiting the investor's circumstances and objectives.

An error common to many unskilled investors is that they employ the wrong ingredient—the wrong *type* of security—to achieve a given objective. They use the appreciation type for income purposes or rely too much upon the income producer as a safety factor, etc. One could produce some kind of an edible, I presume, if he omitted the sugar and eggs from his cake recipe, or substituted something else for them. But his results will be much better if he uses the proper ingredients in proper proportions. He will stand much less chance of getting a stomach-ache, too. So it is with the manager of investments. If he uses the right ingredients in their proper proportions to achieve his objectives, he will in the long run have more income, more appreciation and, most important of all, he will take much less risk of suffering losses.

Perhaps I can make this clearer to you by approaching the problem from *two* directions.

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First I shall discuss the three *objectives*—"Safety," "Income" and "Appreciation," explaining why each of the three "types" of securities should be used, or should *not* be used, to attain the objective under discussion.

After that, I shall discuss each of the three *types of securities* and explain to what extent *objectives* are attained by employing each *type of security*.

THE THREE INVESTMENT OBJECTIVES

SAFETY

The safety objective is achieved primarily through the employment of security Type No. 1—high-grade, short-term bonds and other cash equivalents. Type No. 1, *if properly selected*, is almost always safe, insofar as we are interested in dollar value.

Too great a degree of safety must not be expected from Type No. 2—long-term, high-grade bonds and very high-grade preferred stocks. They will be safe (from downward fluctuation) only during periods of stationary or declining interest rates, for when interest rates rise, high-grade, long-term bonds and very high-grade preferred stocks will decline, regardless of the strength of the issue. Sometimes the decline will be sufficient only partially to offset the income received. A sharper decline will absorb all of the income, and a still more drastic decline will reduce one's principal each year to a greater extent than the percentage of income received.

I was discussing the matter of interest rate trends recently with a woman who was directing the invest-

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ment of \$160,000, all that remained of several hundred thousand dollars left her only a few years ago.

"Why," she asked me, "should high-grade, long-term bonds and very high-grade preferred stocks decline in periods of rising interest rates, and rise when interest rates recede; and why don't short-term bonds do the same?" Here was a woman directing the investment of her fortune—"everything she had in the world to keep her from the poor house"—and by that question she proved that she had no conception whatever of one of the elementary investment theorems. Not only was she without any idea as to what *caused* interest rate fluctuations, but she did not even understand that high-grade, long-term bonds *do* fluctuate, while high-grade, short-term bonds are ordinarily relatively stable. Needless to say, upon further questioning, I found that she harbored many other misconceptions.

Nor must much safety be expected from earnings-dependent securities—those of the Type No. 3 variety—(common stocks and second-grade bonds and preferred stocks).

A student at the Harvard School of Business Administration recently sent me a list of common stocks in some twenty different industries, asking me to check those which I thought proper for an investor "whose objectives were safety and income." I sent the list back with no check marks, whereupon he sent it to me again, calling attention to my "oversight." I then wrote to him at length, explaining that common stocks should be

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used only for appreciation or purchasing power preservation; that they could seldom be classed as "safe" except in the most favorable periods, and that income received from them should be considered merely as a by-product of purchasing power preservation (of which more later).

INCOME

High-grade, *short-term* bonds and other cash equivalents (Type No. 1) *under normal conditions* produce a fair income. The period through which we have been passing (1930-1939), with its extremely low yield on securities of this type, is the exception rather than the rule.

During periods of stationary or declining interest rates, securities of Type No. 2—*long-term*, high-grade bonds, and very high-grade preferred stocks—may be used for income purposes. During such periods safety and income are nicely combined in this type.

When interest rates are rising, however, this type should be avoided for the reasons mentioned above. During such periods the wise investor will fall back on Type No. 1 for such income as he can get and on Type No. 3 for such income as comes as a by-product of the appreciation, or purchasing power preservation, objective. There is little use in collecting a 3 or 4 per cent income from Type No. 2 securities at the expense of a reduction in principal of that amount or more.

Common stocks, and second-grade bonds and preferred stocks (Type No. 3), should never be employed with income as the chief objective. They may perhaps pay an income,

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when employed for appreciation purposes, but income should be considered merely as a by-product of the appreciation objective. The small additional income to be derived from earnings-dependent securities, *in itself*, never warrants the risk incurred. *If risk is to be assumed, there should be a greater possible reward than a mere 1 or 2 per cent of additional income.*

APPRECIATION

Today's investor is confronted with a problem which many of his predecessors have not had to consider. The gold content of our dollar has been reduced. Furthermore, a base for credit has been created, the like of which has perhaps never been equaled. Both of these conditions presage higher living costs as time goes on. If living costs double during the next few years, the investor who merely conserves his capital will have lost half of it (as far as purchasing power is concerned)—just as surely as though prices remained the same while he lost half his principal.

Today's investor, therefore, paradoxical as it may seem, must realize that merely to conserve, is probably to lose. To remain even, he must make a profit! To seek appreciation—under other circumstances an aggressive move—today is a defensive procedure. On the one hand lies the admitted risk of employing Type No. 3 securities; on the other, the risk of loss of purchasing power. Under *competent* investment management, the seeking of appreciation seems to involve less risk than would the loss of purchasing power. Under

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competent investment management, a reasonable degree of appreciation may be secured during favorable periods with little risk, while rising living costs are *sure* to reduce purchasing power in proportion to the extent of the rise.

Practically no appreciation can be secured from Type No. 1 securities—short-term bonds and other cash equivalents.

A limited degree of appreciation may be secured from securities of Type No. 2—long-term, high-grade bonds and very high-grade preferred stocks—*but only during periods of declining interest rates.*

Appreciation, or purchasing power preservation, must be achieved largely by employing Type No. 3—"earnings-dependent securities" (common stocks, and second-grade bonds and preferred stocks). Here is where the investment manager must have, and exercise, a high degree of judgment. Just because common stocks, for instance, are the best medium for achieving appreciation, does not imply by any means that they should be employed all the time—in 1931, for example, as well as in 1928. In fact the question of when to hold a reasonable percentage of common stocks in an investment account, and when not to, is one of the most important, if not *the* most important, part of investment management. I shall have a great deal to say to you on this subject in subsequent letters, the purpose of this letter, you will recall, being merely to introduce to you the three general *types* of securities, and to relate them to the three objectives of investment management.

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Type No. 1 is best for safety, produces a moderate income under normal conditions, and affords little opportunity for appreciation.

Type No. 2 produces a moderate income, some appreciation when interest rates are declining, and is safe from downward fluctuation only when interest rates are stationary or declining.

Type No. 3 is best for appreciation or purchasing power preservation (but only when conditions are favorable). Whatever income is received should be considered as a by-product. This type should never be employed for safety.

Below is a table which may be of some assistance to you in assigning the three general types of securities to the investment objectives for which they are best adapted.

| <i>Type of Investment</i> | <i>For Safety?</i> | <i>For Income?</i> | <i>For Appreciation?</i> |
|--|--|---|--|
| <i>Type No. 1:</i> Short-term, high-grade bonds and other cash equivalents. | Yes | Moderate income will be derived under normal conditions. | Little or no opportunity for appreciation. |
| <i>Type No. 2:</i> Long-term, high-grade bonds and very high-grade preferred stocks. | Only in periods of stationary or declining interest rates. | Moderate income will be derived—depending upon current interest rates and the price at which purchased. | Some appreciation may be secured in periods of declining interest rates. |
| <i>Type No. 3:</i> "Earnings-dependent" securities—common stocks, and second-grade bonds and preferred stocks. | Should never be employed for safety although <i>properly</i> selected issues will be reasonably safe if held at the right times. | Consider whatever income you get as a by-product of your endeavor for appreciation. | Opportunity for appreciation if held at the right time. |

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It is the confusion in the mind of the investor regarding the respective functions of the three types of investments which often breeds losses. If, for instance, he uses Type No. 2 for safety or income, regardless of interest rate trends, or Type No. 3 for income without regard for economic conditions, he is *practically certain, sooner or later, to suffer losses which will deprive him of more principal than he has gained in income.*

I have made the above general comments on *the three types of securities and their relation to the three investment objectives* because the percentage of earnings-dependent securities (common stocks, and second-grade bonds and preferred stocks) in your list seems inordinately high to me. An investor's first decision, in setting up his investment account, should be to determine the *maximum* percentage of earnings-dependent securities that he will *ever* own—even under most favorable conditions. This maximum percentage will depend upon the investor's circumstances and objectives, and to some extent upon his preferences—if they (preferences) are in line with his circumstances. One investor's circumstances and objectives may permit a *maximum* as high as 80 per cent, another's 60, and still another's 40, or even less. In periods unfavorable to business the investments in earnings-dependent securities should be reduced or perhaps they may be eliminated entirely—depending upon the apparent seriousness of the situation. From what you have told me of your circumstances, objectives and preferences, it

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seems to me that you are assuming too great a degree of risk, particularly in view of current economic conditions.

There are a number of other comments I should like to make, but before mentioning them, perhaps it would be advisable for you to let me have your reaction to this letter.

Looking forward to hearing from you again at your convenience, I beg to remain,

Very sincerely yours,
H. G. CARPENTER

Letter No. 2 . . .

LONGER-RANGE ECONOMIC CONDITIONS

DEAR MR. SMITH:

Your letter of the twentieth received and I am happy indeed to know that you are favorably impressed with our suggestion that your first step should be to decide upon the maximum percentage of your investment account ever to be invested in earnings-dependent securities.

I am also pleased to note that you subscribe to our custom of classifying "bonds and preferred stocks not of the highest grade" along with common stocks, as "earnings-dependent securities." While the losses you have sustained by relying too much upon the designation "bond" are regrettable, your experience, you may be sure, has been duplicated by thousands of other investors.

In my last letter I discussed the three *types* of securities in their relation to the three investment objectives. In this one I want to tell you some more about those three *types* and give you some idea, if I can, of the importance of determining *when and in what proportions* they should be employed to achieve their respective objectives.

Of the three types, we have seen that No. 1—short-term, high-grade bonds and other cash equivalents—are the safest, if properly selected. We have seen that *long-term*, high-grade bonds and very high-grade preferred stocks, Type No. 2, are less safe than Type No. 1, because of price changes caused by interest rate fluctuations. And finally we have

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seen that Type No. 3, "earnings-dependent" securities (common stocks, and bonds and preferred stocks not of the highest grade), are the least safe of all—*particularly if employed at the wrong time.*

The above paragraph embodies two thoughts of utmost importance in the successful management of money.

1. Long-term, high-grade bonds would be just as safe as those of short term, were it not for interest rate fluctuations.
2. "Earnings-dependent" securities are least safe, "particularly if employed at the *wrong* time."

The significance of those two statements cannot be over-emphasized. The grade or quality of an investment is important, to be sure. But frequently of far greater importance is *the period in which you hold it*. It is not only *what* you own, but *when* you own it, that is vitally important if good investment results are to be achieved.

Let me illustrate first how the value of long-term, high-grade bonds may fluctuate. The Dow-Jones Bond Market Average of ten high-grade railroad bonds stood at 87.61 in December 1918. Two years later it had declined to 69.60, a drop of 20.6 per cent. The bonds were sound enough. The statistical services rated them all as high grade in 1918. But interest rates had risen. Long-term, high-grade bonds *had* to decline. *The strength of the issuing company or the number of times interest charges were earned could do nothing to stop it.* The important thing was the rental value of money, for that is what governs the price of long-term, high-

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grade bonds. There have also been occasional instances of drastic declines in bond prices due to panic or fear, such as the May 1931 to May 1932 decline of 21.7 per cent.

What I want to impress upon you is that the careful selection of individual issues of long-term, high-grade bonds is only *part* of the job—and frequently by far the smaller part. The trend of interest rates is the important consideration in the bond portion of an investment list. As I write this, the Dow-Jones Market Average of ten high-grade railroad bonds stands at 92.40. The statistical organizations rate all of the issues as high grade. But if, during the next few years, the rental value of money (interest rates) rises, those bonds will decline regardless of their strength. If it rises fast enough, they will decline enough to offset the interest they pay. If the rise is more abrupt, they will decline more each year than the interest they pay. Of what avail is it to pay \$1000 for a bond today, collect \$30 interest during the coming year and then perhaps see the price of the bond \$970 a year from today—or perhaps \$960 or \$950, or even less?

One hears people say that they don't care about price fluctuations as long as their securities are sound—that they will be paid at par when due, etc., etc. These people are not taking into consideration the possibility that they might need to sell their bonds when the price is down, that they may die at the wrong time, or that, if they are properly advised regarding interest rate trends, they may be able to buy today's \$1000 long-term bond at \$900 or \$800 if they will hold off several years and use short-term bonds in the interim.

When we get to earnings-dependent securities—common

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stocks, and second-grade bonds and preferred stocks—there is, of course, a far greater possibility of fluctuation. That is why this type of security is so much less safe. The Dow-Jones Index of Industrial Stock Prices, for instance, stood at approximately 335 on July 1, 1929 and at approximately 45 three years later, a downward fluctuation of 86 per cent.

The best stocks declined as well as the poorer ones. The common stock of American Telephone and Telegraph Company sold at \$310 per share on September 9, 1929, and at \$70 on July 11, 1932, a decline of 77 per cent. The common stock of American Can Company, another high-grade issue (which also paid its dividends all through the 1929-1932 depression), stood at \$184 on August 24, 1929, and at \$30 on June 27, 1932, a decline of 83 per cent.

What you must understand is that the strength of the company or the grade of the issue is no guarantee against serious loss, when considering common stock values for several years ahead. With few exceptions, the good issues decline as well as the poor, and many of the poor issues also rise to some extent when the good ones go up. *The important thing is to be able to distinguish, with a fair degree of accuracy, periods of generally rising values from those of generally falling values.* Just as it is of vital importance in bond investment to determine the longer-term direction of interest rates, so in common stock investment, one must be able to foresee the direction of business activity and commodity prices with a fair degree of accuracy, and to understand the significance of a score of other factors—social, po-

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litical and economic—which also have a bearing on the problem.

Let us not, then, be deluded by the conventionally conservative reasoning that the financial strength of a company, or its earnings record, is the *chief* concern of investment management. The *major* problem, both in bond investment and common stock investment, *is to have one's list properly adapted, by types, to the character of the period.* For example, if one could have been a perfect investment manager, he would have carried few, if any, common stocks in the depression period of 1929-1932; he would have carried a substantial percentage from 1932 to 1937; a small percentage during the 1937-1938 decline and a fairly substantial percentage from March 1938 to the date of this writing (September 1939). He would not carry too great a percentage of long-term bonds when interest rates are rising, and vice versa.

The vital problem is to recognize the more important trends.

The most serious *losses* occur by *not* properly adapting one's investment list to the character of the period.

The safest *appreciation* is secured by *having* one's list properly adapted to the period.

The conclusion cannot be evaded, therefore, that the recognition of major investment market changes is a most important part of investment management. Some investment advisers contend that it is impossible to estimate future major economic changes. It certainly is impossible to do so with 100 per cent accuracy, but to be of investment advantage it is only necessary that such estimates be right a little more than half

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of the time. To select the *companies* within an industry that have the best outlook obviously involves the ability to foresee future conditions to some extent. The same is true in appraising the general outlook for an *industry*. As a matter of fact, investment on any basis necessarily involves judgment regarding the future. To take the position that it is impossible to have any judgment regarding the future is, in effect, tantamount to the assumption that the future will be the same as the present.

The best sources of information for the recognition of such changes, I shall discuss in a later letter.

Sincerely yours,
H. G. CARPENTER

Letter No. 3 . . .

"TIMING"

DEAR MR. SMITH:

In your letter of the twenty-fifth, in reply to mine on the subject of "Longer-Range Economic Conditions," I fear you have misinterpreted my thought—to some extent at least.

It is true, as you have suggested, that I mentioned *only* the four more important declines and rises of investment values since 1929, i.e., (1) the decline from 1929 to 1932, (2) the rise from 1932 to 1937, (3) the decline from 1937 to 1938, and (4) the rise since 1938. I purposely ignored such investment market movements as the sharp, short decline of stock prices in July 1933 and the decline from November 1938 to April 1939. Perhaps your conception of "timing," and mine, do not exactly coincide.

"Timing," unless carefully defined and qualified, can easily become dangerous. The competent investment counsel, if he uses the term at all, may talk about it and mean *one* thing. The speculator, sitting in a broker's office, uses the same term but means something entirely different. And, between these two, there may be a score or more of conceptions of the meaning of the expression. And then, too, there is the type of investor who "puts securities away in his box and forgets them" and the "common-stocks-as-long-term-investments" adherent who "buys good stocks and hangs on to them."

If I were to try to condense this letter into a sentence,

"TIMING"

I should say that "timing" should generally be thought of in terms of years, rather than in terms of days, weeks, months or quarters. While I am unsympathetic to the thought of putting securities away and forgetting them, nevertheless had I to choose between that fallacious theory on the one hand, and the in-and-out-trader method on the other, I should most certainly choose the former, unsound as it is, for net results over any reasonable period.

The competent investment manager, when he refers to "timing" or whatever other term he may use, means that he hopes, on the one hand, to recognize such serious declines in general business activity and security prices as the 1929-1932 or the 1937-1938 depressions. On the other hand, he aims to discern with a fair degree of accuracy, such favorable major investment situations as 1932 or 1921. He expects to pay no attention to the shorter-term stock market movements. As to bonds, he has the same things in mind—to distinguish the long periods of rising interest rates (and falling bond prices) from those of declining interest rates (and rising bond prices)—and to foresee, with some degree of accuracy, such an unprecedented recession as the fear-inspired bond relapse in 1931-1932.

The trader or speculator, however, is not satisfied with this cautious, truly conservative procedure. His hindsight shows him that the common stock averages declined 10 per cent in April, for instance, or 16 per cent from October to March, and he sees no reason why he or his investment adviser could not have "timed" a sale of his securities at the high in early April and bought in again in May,

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sold again in October and repurchased in March. He will not concede that there must be a factor of error in selling out and buying in again. He freely admits that it would have been marvelous management to have avoided common stock investments *all through* the depression from 1929 to 1932, but could not bear to see a month or two of rising prices in early 1930 without getting into common stocks, regardless of dangers which were present in the situation. While admitting, as mentioned above, that staying away from common stocks *all through* the 1929-1932 depression would have been excellent management, he has forgotten that there were several periods of months at a time in 1929-1932 when common stock prices advanced very substantially. The Dow-Jones Industrial Average advanced over 50 per cent from December 1929 to April 1930, and approximately 28 per cent during the first two months of 1931. Think of the anguish which would have been endured by this type of investor during those periods, although he must admit, in longer-term retrospect, that to avoid common stocks all through the 1929-1932 depression was the wisest course. Those unfortunate investors who did try to trade in and out during the 1929-1932 depression almost without exception lost a large part of their capital. More money, by far, was lost in 1930, 1931 and 1932 than in 1929.

The "short-swing trader" is also extremely critical of himself or his investment adviser when an unforeseeable relapse occurs, such as the July 1933 three-day decline of approximately 20 per cent. He knows from *experience* that such reactions always have occurred and presumably always will

"TIMING"

occur and that there is no way of foreseeing them. He may know, too, from experience that the investor who tries to "catch" such reactions inevitably has unsatisfactory results over the longer term, but that plaguing devil, hindsight, still whispers, that *if* he had sold on July twelfth, he would have avoided the decline.

Unfortunately this type of investor does not always profit by his own experiences. He may have lost scores of thousands of dollars in his attempts at "short-swing timing" during the same period that a competent investment manager has lost little or nothing. Or during a more favorable period he may have had only half as much appreciation as the competent investment manager. But his proneness to hindsight dulls his recollection of the unprofitable experiences. He still sees what he *might* have done if only his "timing" had been better. He would be a perfectionist in a business in which there is no such thing as perfection; an exact scientist in an inexact science. His conception of "timing" is an entirely different one from that of the successful investment manager or counsel.

From the above remarks you will have gathered that there are two extremes and a middle ground to this "timing" business. At one extreme there are the "put-it-away-and-forget-it" adherents. At the other extreme we have the trader or speculator with whom "timing" is almost a mania, and near him are others who think entirely too much about it. In between those two extremes we find the competent investment manager (he must be *competent*) whose longer-term results, in comparison with the other two, have proved

THE LETTERS OF AN INVESTMENT COUNSEL

the superiority of his methods. He is ever on the alert for signs which may indicate the approach of an *important* economic change, but beyond that, he is not interested in "timing."

Every investor must decide for himself what policy he prefers and then select his investment advisers accordingly, if he employs an investment adviser. If you decide to follow the middle course, neither favoring the "put-it-away-and-forget-it" plan, nor yet subscribing to a trading policy, then you *must* reconcile yourself to those seemingly unwarranted and certainly unforeseeable "short swings." Often such reactions have been pool manipulated. Surely no one would expect to read the minds of a group of unknown market speculators, who had decided to sell stocks short for a few days or weeks during a generally rising market, or buy them during a generally falling market. With the thinness of markets resulting from the restrictions now placed on security trading, we must expect reactions of greater magnitude than heretofore.

And then, too, the very nature of the securities markets is to suffer and enjoy alternate periods of fall and rise. You must decide either to try to "catch" these "short swings" or ignore them entirely. Like so many other investment misconceptions, the effort to "time short swings" sounds conservative to the investor who has not thought it through. His intention, of course, is to avoid losses by proper "timing" of downward reactions in an up-trending market, and to make a profit by successful timing of upward reactions in a down-trending market. Actually, however, such efforts

"TIMING"

are productive of results just the reverse of his conservative intentions. In my experience, nine out of ten of the people who attempt "short swing timing" have been unsuccessful in their longer-term investment results. On the other hand, nine out of ten of those *competent*, truly conservative managers, who have proved their ability to foresee a majority of the major investment market trends with a fair degree of accuracy, have been successful. When one is confronted with such overwhelming evidence of the superiority of the one method over the other, is it not obviously the part of wisdom to employ the successful method?

It will hurt, and hurt badly in *immediate* retrospect to see what you *might* have done, but you must steel yourself against hindsightedness. You must realize that the chances of success are conservatively five to one in favor of disregarding "short swing" reactions entirely. It should console the trading-minded investor to know that the anguish of the timing perfectionist is short lived. I have talked to a score of them and not one recalled that common stocks declined nearly 20 per cent in July 1933, nor that they advanced 50 per cent and 28 per cent respectively in the two mid-depression (1929-1932) advances. I am told by an investment counsel who was in business at that time that many of his clients (even though told in advance that he ignored "short swing reactions") suffered great anguish during, and immediately subsequent to, that 20 per cent recession in July 1933. The average account under his direction, however, showed a substantial gain for the year 1933 in spite of this 20 per cent decline. In the after-calm of longer-term invest-

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ment success, he says, they have realized that July 1933 was merely an unpleasant, unavoidable, though regrettable incident.

There is another grave difficulty involved in the intermingling of trading activities with investment management—a psychological difficulty. The trader becomes so mentally enmeshed in the technical intricacies of his craft that he *cannot* maintain the calmness and the deliberateness which are so essential to successful long-term investing. I know a brilliant trader who, in the spring of 1937, foretold the approaching decline in common stock values with remarkable accuracy. If he could have desisted from further trading activities for a year, his 1937-1938 depression record would have marked him as an outstanding investment manager. But he could not desist. July saw him weakening. He could not stand the rise in August to a point approaching the March high. "The market" was "moving." He had to be "in there, doing something about it." It might "get away" from him.

He bought common stocks in August, sold them in October (just *before* a temporary rise), bought again in January 1938 and sold again during the March 1938 decline, at prices near the bottom of the 1937-1938 depression. His results for the year were far inferior to those of competent *investment* managers who, while less "brilliant," pursued a less spectacular course. It is always the same story. The greatest speculators in American financial history—Keene, Livermore, Durant and all the rest—have become so saturated with the excitement of trading that it was psychologi-

"TIMING"

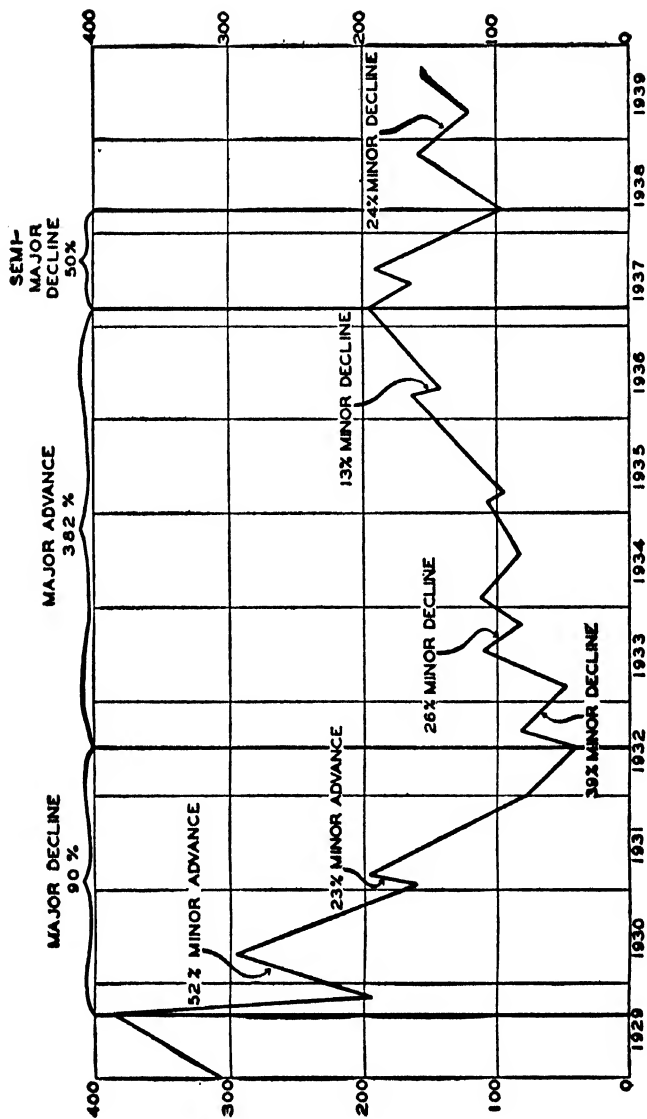
cally impossible for them to maintain the balance and poise essential to long-term investment success. Sooner or later they all lose.

This subject of "timing" is provocative. Most of us have to go through the experience of trying to be too accurate at it before we become convinced that better results will always be achieved, over any reasonable period of time, if we limit our efforts to attempting to foresee only the major economic changes. We won't be successful even in doing that, but if we can foresee a majority of important economic changes with a fair degree of accuracy, our results will be far better than those of the trader, I can assure you. "Timing" is a much-abused word, and a *dangerous* practice.

Very sincerely yours,

H. G. CARPENTER

P. S. On the next page you will find a rough chart illustrating the difference between *major* and *minor* advances and declines in the values of common stocks. Note that some fluctuations, even though as great as 50 per cent, must, in the light of later developments, be called "minor."



It is of course, at this writing (October 1939), too soon to say whether the rise from March 1938 is a major rise or a minor advance in a major decline from March 1937. Likewise it cannot be said with certainty, as yet, whether the 1937-1938 decline was a major decline or a minor decline in a major advance from July 1932.

Letter No. 4 . . .

INDUSTRIES AND GROUPS

DEAR MR. SMITH:

Thank you for your letter of the thirtieth from which I am pleased to note that you agree with our conception of what "timing" should involve.

I also feel sure that you agree with us that the *most* important part of investment management is the recognition of major investment market trends with a fair degree of accuracy; and you understand the importance of adapting your investment list to the character of the period in which you find yourself, by changing the percentages of the three *types* of securities.

Next, let us contemplate the step which is of *second* importance. Before we begin to think of individual companies or security issues at all, we must consider the various *industries* and the several groups into which they naturally fall.

GROUPINGS

STABLE VS. CYCLICAL EARNINGS

One method of classification which can be applied to all earnings-dependent securities—common stocks and the lower-grade bonds and preferred stocks—relates to their stability of earnings. One group of industries, producers of "consumer, non-durable goods" (including among others, the tobacco companies and the food companies), may be characterized

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generally, as "stable earners." That is, their *earnings* are fairly stable throughout periods of depression and prosperity alike. Opposite these we find another group of industries—the producers of capital or durable goods—whose earnings are very *unstable*. This group includes, among others, the steel industry, the machine manufacturing industry and the railroad industry. The earnings of this group are extremely cyclical—that is, their earnings vary substantially in different stages of the general business cycle. These industries are likely to report very large earnings in periods of prosperity and very poor earnings, if not deficits, in periods of depression.

A common investor mistake, as I have said before, is to assume that the common stock of a company enjoys a high degree of safety just because that company is a stable earner. We saw that the price of the common stock of American Can Company declined 83 per cent during the 1929-1932 depression, and the common stock of American Telephone and Telegraph Company, 77 per cent. These companies are "stable earners" but during the 1929-1932 depression they declined almost as much as those with more "cyclical" earnings. Therefore, we may emphasize here again, that stability of earnings is no guaranty of stability of price, and may conclude that, defensively, in guarding against *serious* losses, the stable-earning characteristic affords little protection.

There comes a time, however, when our knowledge, if we have it, of the investment characteristics of the various industries *is* of value. In the early part of "recovery"—that period which follows depression and precedes prosperity

INDUSTRIES AND GROUPS

(when, normally, interest rates are falling rapidly), the skilled investment observer has noted that the common stocks of the best companies of the stable-earning industries often are the first to advance; and that they usually advance *during that period* with greater rapidity than do the shares of companies representative of the more "cyclical-earning" industries. In this respect the common stocks of the best companies of the stable-earning industries are similar to bonds.

On the other hand, visualize a period of "liquidation"—that period which follows prosperity and precedes depression. Business activity is decreasing. There is little demand for capital. Interest rates are declining, and bond prices, consequently, rising. Here the common stocks of the best companies of the stable-earning industries, those which pay substantial, steady dividends, will normally decline more slowly than the common stocks of the more highly cyclical earners. In other words, common stocks of the best companies of the stable-earning industries again partake, to some extent, of the characteristics of high-grade bonds.

With this single example of the advantages to be derived from classifying common stocks either as stable or cyclical earners, let us proceed to another possible grouping.

CONFORMITY OF EARNINGS FLUCTUATIONS TO THE TRENDS OF BUSINESS ACTIVITY

Another little-understood principle of investment management, which is of great importance to the competent manager, is the relative degree to which the earnings of

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corporations in the various industries conform to the several stages of the major up and down trends of business activity. Earnings of companies in the steel industry, for example, follow these trends closely. They are large in periods of prosperity, and negligible, if not entirely absent, in periods of depression. Many other industries have this same characteristic, notably the railroads, motor and machine manufacturing companies.

Armed with this knowledge, the competent investment manager is not at all surprised when the steel, rail, motor and machine manufacturing companies show dwindling earnings through periods of liquidation and depression. Nor is he at all surprised, during such periods, at the ever-decreasing prices of their stocks. He expects them to fall to somewhat lower levels, relatively, than those of other companies whose earnings do not fluctuate so widely. He is not "through with the steel companies" because the common stock of United States Steel Corporation dropped from \$250 in 1929 to \$25 in 1932 (90 per cent, as compared with 77 per cent in American Telephone). He knows it was due in part at least to the tendency of the steel industry's earnings to follow the general business cycle closely. He knows that those earnings and prices can come back, at least in part, in periods of recovery and prosperity. He plans to sell his steel, motor and machine manufacturing stocks in the late days of prosperity or early days of liquidation and re-buy them later, when the longer-term business outlook is favorable once more. (On the other hand, the careful student of investments will understand that the fluctuations of

INDUSTRIES AND GROUPS

the common stocks of companies representative of still other industries, such as sugar and meat-packing, do not usually conform at all closely to the trends of business activity.)

I shall not go into details here, but it is well to remember that the earnings of some fifteen, of the thirty-odd industries, conform fairly closely to business activity trends; five or six conform hardly at all, and the rest may be said to be about half way between these two extremes.

Many investors attempt to judge a company by its earnings during the last five years. But if the company is representative of a cyclical industry (in which earnings are high during periods of prosperity and low during periods of depression) then the very fact that earnings *have been good* during the *last* five years may be an indication that they are going to be *poor* during the *next* few years. One cannot rely upon an earnings record unless he understands the character of the *industry* to which a company belongs.

I am sure you see the tremendous advantage this information gives to the investment manager who is possessed of it, and how it eliminates an important part of the uncertainty in the management particularly of earnings-dependent securities.

EARNINGS FLUCTUATIONS AND COMMODITY PRICES

A third grouping might comprise those industries whose earnings depend largely upon certain commodity prices. Copper is a good example. In 1929 when copper was over twenty cents a pound, Anaconda Copper Company made

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a profit of approximately \$69,000,000.¹ In 1932, with the price of copper less than eight cents, Anaconda *lost* \$27,700,000.¹ Numerous other industries besides copper owe their prosperity not so much to low interest rates, or to the trends of business activity (as in the two groups cited previously) as to the price of some certain commodity. Some industries are affected more by current price; others by the *trend* of the price. In this grouping alone there is presented to the competent investment manager a nice problem—the interrelation of business activity trends with commodity prices being one element; the differentiation between industries whose earnings are affected by current price from those affected by trend in price being another. Furthermore, volumes might be devoted to the subject of the sequence in which the various commodities are likely to advance or decline in price. And there are many other similar problems of which time and space prevent even the mention.

What I have tried to bring out in this letter is the extreme complexity of the second step in *successful* investment management—an understanding of the relationship of earnings of the many *industries*, to the various stages of the general business cycle, and in some instances to the prices of commodities. It is a complicated subject and if I have not made myself clear, please feel free to write to me with any questions which may have come to your mind.

Very sincerely yours,
H. G. CARPENTER

¹ Before depletion, which the company does not report.

Letter No. 5 . . .

SELECTING INDIVIDUAL COMPANIES

DEAR MR. SMITH:

After realizing the necessity of knowing where we are in the long trends, and after appreciating the importance of the characteristics and tendencies of the various *industries* and/or groups of securities, we may now proceed to think of the selection of individual companies.

Some time ago the investment counsel organization with which I am affiliated sent out to a number of investors an "Investment Management Questionnaire." The purpose was to provide the investor with a means of testing his own investment management ability. Among the questions was this one: "Name ten facts to ascertain regarding any company in whose stock or bonds you propose to make an investment."

Few of those who answered the questionnaires could think of ten questions to ask! I mention this because I want to impress upon you that many investors, besides neglecting the two *most* important steps—trends and industries—do not even know what they *ought to find out* about the company itself before investing in it. Nor do they have the facilities for finding out, even though they know what to look for.

The "pattern for analysis" which our organization uses in checking a given company's securities includes *seventy-four* items! It is not always possible or necessary to get information on each and every item, but the list of seventy-

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four points is a constant guide to the analyst. While the analysis and comparison of individual companies is of less importance than either of the steps heretofore discussed, it nevertheless requires more time and a larger personnel than either of the others. I shall not bother you with the last fifty items of our "pattern for analysis," but just to give you a good start here are twenty-four questions which might be asked regarding a manufacturing company:

1. Age and stage of development
2. Table of annual output
3. Ratio of company's annual output to that of entire industry
4. Table of annual earnings as far back as possible
5. Character of the present management, control and banking connections
6. Number of plants and where situated
7. Distance from raw materials and markets
8. Labor supply
9. Transportation problems, if any
10. How location affects character of company's output and general operations
11. Types of products
12. Percentage distribution of sales to chief types of consumers
13. How does the company differ, with regard to relative importance of types of products, from other comparable companies in the industry?
14. Profit-determining factors—are these different in any important respect from those in the general industry?

SELECTING INDIVIDUAL COMPANIES

15. Selling prices
16. Costs
17. Profit margins
18. Raw material supply
19. Distributive mechanism
20. Demand for product
21. Anything concerning government regulation or interference relating particularly to this company
22. Labor difficulties
23. Patents
24. Import and export position

With little preparation in the one phase of investment management to which they usually limit their investigation—company analysis; with little conception of the long economic trends and their evidences; and with only a partial understanding of group or industry characteristics in relation to those trends, is it any wonder that many investors lose more money than they should in periods of decline, and obtain less appreciation than they might, in periods of prosperity?

To summarize the successful investment manager's major problems:

1. He should be thoroughly versed in economics, with the *causes* of business and investment market trend changes. He ought to have at his command several hundred indexes or series of economic and statistical data, the very minimum estimated cost of which, in-

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cluding their transcription to usable form, would run into many thousands of dollars per year.

2. He should understand the characteristics of some thirty-odd major *industries*, and be able to understand their reactions, and the sequence of their reactions, to the more important trends of business activity, interest rates, commodity prices, political happenings (both domestic and foreign), and to social developments.
3. And he should, of course, be familiar in a general way with the financial history and present condition of at least several score of corporations.

That, I believe, is a fair statement of the major problems of investment management.

Sincerely yours,
H. G. CARPENTER

Letter No. 6 . . .

GUARDING AGAINST DANGERS

DEAR MR. SMITH:

Just one more short letter under the general subject of "The Major Problems of Investment Management."

The investor's first concern should always be the preservation of the capital value of his fund, for the climb back is almost always slower and more difficult of achievement than the road down.

The climb back is "slower" because it is the nature of longer-term trends to decline swiftly and to rise slowly. The 1929-1932 decline, for instance, in the comparatively short period of thirty-three months, erased a gain in common stock prices which had been eight years in the making.

The climb is "more difficult of achievement" because it actually is farther up than it is down. Assuming a fund of \$100,000, one might be tempted to believe that a decline, let us say, of \$20,000, is no greater than a rise from the remaining \$80,000, back to \$100,000. But such is not the case, unfortunately. A decline from \$100,000 to \$80,000 represents a loss of 20 per cent. But a rise from \$80,000 to \$100,000 *requires a gain of 25 per cent*. Carried a step farther, a decline of 33 $\frac{1}{3}$ per cent necessitates an appreciation of 50 per cent to recover the loss; and a decline of 50 per cent requires a gain of 100 per cent!

It is for the above reasons that a high degree of caution is always advisable in the management of investment funds.

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The percentage of earnings-dependent securities should always be restricted to accord with the investor's own particular circumstances and objectives. "The smaller the fund, the greater the caution" *should* be the rule. Unfortunately, the opposite is usually the case. The wealthy man or woman, often with a sounder conception of the risks involved in investment, is frequently far more cautious than his less fortunate brother and sister, who are possessed of more limited means. One reason why relatively few investors are successful in increasing their capital is that they try too hard to increase it!

It is difficult in periods when prices are rising to be satisfied with a relatively small percentage of earnings-dependent securities in one's investment account. The wise investor, however, may be consoled with the thought that sooner or later an unlooked-for, sizable and perhaps unpredictable decline will come, which will leave the over-eager investor considerably worse off than the man who has employed a greater degree of caution.

Investment management should not be a scramble for profits. To be successful it must be, first of all, a sincere, competent endeavor to preserve the principal value of a fund. Merely to preserve that value over a period of years is more than nine out of ten investors achieve. To succeed in protecting purchasing power—that is, to secure an appreciation over a term of years equivalent to the increase in the cost of living—should be accepted as a most satisfactory performance.

The result of an investment management program cannot

GUARDING AGAINST DANGERS

be determined, or even estimated, over a short period of time. The best protection against serious loss is to have one's investment list reasonably well adapted, by years (not weeks or months), to the economic, political and social characteristics of the period. Competent, cautious investment managers who attempt merely to foresee the *major* investment market trends will seem to be "wrong" a good percentage of the time, but their *net results*, over any reasonable period, will be better than the short-term trader's.

Sincerely yours,

H. G. CARPENTER

Series II
INVESTMENT ADVISERS

Letter No. 7 . . .

INVESTMENT COUNSEL—HOW IT DIFFERS FROM OTHER INVESTMENT ADVISORY INSTITUTIONS

DEAR MR. SMITH:

I have your letter of the fifth in which you so kindly express your approval of my efforts to present the major problems of investment management. On my part let me say that *I* am appreciative of *your* attitude and your co-operation. In your letters to me you have evidenced a fine grasp of that part of the subject which deals with "what *to* do." Later on, I hope we can approach the problem from that other equally important angle—"what *not* to do."

For the time being, however, let us postpone "what *not* to do" in favor of the subject of investment advisers, to which you referred in your letter.

I fully appreciate your statement that you know you need an investment adviser, but that your several trials have not been productive of good results. There certainly are a multitude of things to watch, statistics to be gathered and investigations to be made. Most important of all, however, is the interpretation of all the statistics and data once they are assembled. It is practically an impossibility for an individual, even with considerable help, to consult over two hundred sources of information and keep up to date the two thousand statistical indexes which are the necessary complement of a properly conducted investment manage-

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ment organization. It is equally impossible for the man or woman, trained for other fields and engaged in other affairs, to apply the necessary interpretative reasoning to the statistics and data after he has them.

There is little, if any, doubt that you, like most other investors, could use an investment adviser to advantage. But, you must find one (1) who has better facilities than you have, (2) who employs methods which you believe to be superior to your own, and (3) who has more ability than you have, as is proved by the results he has achieved. If you cannot find an organization which has that combination of equipment and ability, then you will not be satisfied.

There are thousands of investment advisers in America and from the correspondence I have had with you, I feel safe in saying that you are better equipped, both in facilities and ability, than many of them. They cover a wide range: stock-and-bond salesmen, brokers' "customers' representatives," investment dealers, investment bankers, brokers, some bank and trust companies, statistical organizations, financial journals, "bulletin services," and investment counsel. The array is a formidable one. The fact that there are so many sources of investment advice is the best evidence of the demand for it. Most people realize their deficiencies as investment managers, just as you have, and are seeking competent counsel. But they want *competent* counsel. Let me see if I can't be helpful.

The task of finding competent investment advisers is not

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difficult *if you will approach it in a logical manner*. There are four steps to take.

You must come to a decision, first of all, regarding the *class* of adviser you want. By "class" I mean the kind of advisory institution. Shall it be:

1. An investment banker?
2. An investment dealer?
3. A broker?
4. A stock-and-bond salesman?
5. A broker's "customers' representative"?
6. A commercial bank?
7. A trust company?
8. A statistical organization?
9. A financial journal?
10. A bulletin service or "service"?
11. An investment counsel organization?

1. An "investment *banker*" is primarily an organization which finances the requirements of businesses which want to borrow money (sell bonds) for a longer period than commercial banks want to loan it, or which want to raise money by selling blocks of preferred or common stocks in their companies. The term "banker" implies that the investment banker pays the borrowing corporation first, and then sells the bonds or stock. In other words, he "banks" the transaction until he can sell the securities through his own retail organization, or to other investment bankers or investment *dealers*. His profit lies in the commission, wholesale and retail, which he receives for selling.

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2. An "investment *dealer*" is primarily an organization which sells to investors at retail the securities which are "originated" or "banked" by the investment banker. His profit lies in the commission he receives for selling.

3. A "broker" is primarily an organization which buys and sells securities for its customers. As a rule the broker is a member of one or more stock exchanges and is compensated by buying and selling commissions specified by the exchange. The broker's position differs somewhat from the investment banker's or investment dealer's, in that his commissions are uniform on all securities of a given price. Some brokers, however, are also investment bankers or investment dealers.

4. Almost all investors are acquainted with stock-and-bond salesmen. They are employed by investment dealers and investment bankers to sell securities and are compensated, directly or indirectly, in proportion to the sales profit they make for the firms by which they are employed.

5. A broker's "customers' representative" occupies a similar position with a stock and bond brokerage establishment, except of course that his duties involve the promotion of purchases and sales of listed securities rather than the sale of investment banker originations.

6. A commercial bank's chief function is that of making short-term loans, usually not in excess of ninety days. Many of them also conduct savings departments, engage in the trust business and buy and sell mortgages. Their sale of "securities," as the term is usually conceived, has been limited by federal law to municipal bonds. The commercial

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bank's income is derived chiefly from the loans it makes and from the interest received on bond and mortgage investments.

7. The chief business of a trust company, as the word "trust" implies, is to act as a trustee. Many of them also conduct savings departments and buy and resell mortgages and municipal bonds. Their income is derived chiefly from their fees as trustee and from mortgage and bond interest.

8. The chief function of a statistical organization is to compile statistics regarding corporations and governmental bodies whose securities are on the market, i.e., to record and publish that which *has* happened. Their chief income is derived from the sale of that information to all others who are interested in securities.

9. The chief function of a financial journal is to publish financial news. The financial journal's major income is derived from subscriptions and advertising.

10. "Bulletin services" are organizations which purvey investment advice by means of a daily, weekly or monthly "bulletin," identical copies of which go to all subscribers. Their income is derived from subscriptions to their bulletin.

11. An investment counsel organization is one which is engaged in the business of advising a private clientele regarding their investments on an individual, personal basis. Their income is derived from fees paid them by their clients.

Aside from the above brief remarks regarding the major functions and chief sources of revenue of each class of ad-

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viser, I shall limit myself to a discussion of investment counsel,¹ and tell you why I believe the institution will serve you better than any of the others listed above.

I bought a house recently, and went to a prominent firm of attorneys in the town in which I live, to have them check up on the title. The first question asked me by Mr. Fuller, the partner with whom I talked, was: "From whom are you buying this house?" When I told him, he said he was sorry that his firm could not check the title for me as they were the lawyers for the bank from whom I was buying.

"You see," said Mr. Fuller, "it would not be ethical for us to represent both sides. You might want to bring suit against the bank sometime, and we could not serve both the plaintiff and the defendant. Or, perhaps you are giving a mortgage to the bank. We could not pass on the terms of the mortgage for you, without bias, when we are at the same time drawing the mortgage for the bank. Or to put it the other way around, suppose you were *buying* a mortgage *from* the bank. The bank is the seller and you, the buyer. Your interests and those of the bank are diametrically opposed.

Frankly we are biased in favor of the bank because they have been our clients for many years. I am sorry but we cannot represent your interests in this transaction."

There is no better illustration of the ethics of a reputable investment counsel organization than the above. Investment

¹ The problems of several classes of investment advisers were discussed at some length in *A Successful Investor's Letters to His Son*, by the author.

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counsel should be a profession with the same high standard of ethics that marks high-grade law firms.

The first tenet of investment counsel is that those who practice it must not engage in any other business that places their interests in opposition to those of their clients. Imagine a firm of lawyers who are also active real estate brokers. It would be difficult indeed for them to be impartial in their advice on real estate matters. On the one hand, would be the fee from you for their legal services; on the other, the much larger commission they could earn by making a sale. One would prefer a lawyer whose sole occupation is the legal profession.

You might contend that the investment counsel organization with which I am associated could just as well have another department, engaged in some other business; that we would not let the other business have any influence on our advice to our investment counsel clients. We *could*, under present laws and existing SEC regulations, conduct other businesses, but that would not be "investment counsel" as we conceive it.

"The first tenet of investment counsel is that those who practice it must not engage in any other business that places their interests in opposition to those of their clients." The investment counsel profession, like the legal profession, believes that other interests might *become* conflicting interests. We do not say that if we were engaged in some other business, we necessarily would let that business interfere with our counsel to clients. We believe, simply, that the best plan is not to engage, in the first place, in any other busi-

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ness which might eventually bring our interests in opposition to those of our clients.

As I have mentioned before, there are thousands of investment advisers in America, ranging from stock-and-bond salesmen to investment counsel organizations. You should decide first which of the eleven different sources you want to engage as your adviser. Here you must bear in mind that after the original success of investment counsel and its general acceptance by large investors, many of those in other businesses have begun to call themselves "investment counsel," even though they are engaged in other endeavors. You must therefore decide also whether you want to retain an investment counsel who is an investment counsel *only*, or one who operates an investment counsel department in conjunction with some other business.

So much for step No. 1 in selecting a competent investment adviser.

Steps No. 2, 3 and 4 will be covered in my next three letters.

Very sincerely yours,
H. G. CARPENTER

Letter No. 8 . . .

INVESTMENT MANAGEMENT METHODS

DEAR MR. SMITH:

All is not gold that glistens.

Likewise the title "INVESTMENT COUNSEL" *does not necessarily imply that the self-styled investment counsel is a competent investment adviser.* You must look for *proof of ability* by ascertaining (1) the methods employed, (2) the facilities of the adviser, and (3) the record of results your prospective adviser has achieved *in the past.*

In this letter I am going to tell you about "investment management methods," than which there is nothing of greater importance to the investor, except the results achieved by those methods.

There are six different methods in use, as follows:

1. *The "individual security" method*

This, unfortunately, is the method followed by many, if not most, lay investors. They buy securities, one at a time, solely on the strength of the obtainable statistical data (such as earnings record, character of management, banking connections, etc.) with little or no thought of the character of the period in which the purchase is made, or of the suitability of the security to their circumstances and objectives.

A glance at the record of stock and bond prices during any depression period, as we have seen, will show that practically all securities of a given type decline during such

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periods, *regardless of their statistical position*. Thus during the 1929-1932 depression, when the stock market average declined 86 per cent in value, the common stocks of Allied Chemical Co., General Electric Co. and General Motors Corporation declined 88 per cent, 92 per cent and 92 per cent respectively. During the 1937-1938 depression, when the stock market average declined 50 per cent, the securities of these same companies declined 52 per cent, 58 per cent and 67 per cent respectively. The splendid statistical position of these companies afforded little protection to the investor during those periods when the general trend of common stock prices was downward. The same thing is true of preferred stocks, and of bonds of like grade and maturity.

The error in employing the individual security method lies in the failure of those who employ it, to realize that statistical data regarding security issues, important as those data may be, must be considered as subordinate to a determination of the major trends of general business, interest rates and security prices.

2. *The "invest-for-a-high-income" method*

This method resembles No. 1 except that income is the paramount consideration. I shall have more to say farther on about investing for income. For the time being, let us not forget that interest rates vary from time to time. During one period it may be entirely safe to seek a 6 per cent return on investments. During another, only 3 per cent may be sought without assuming great risk.

The error of investing for a high income lies in the failure

INVESTMENT MANAGEMENT METHODS

of those who employ that method to realize that interest rates fluctuate—sometimes drastically. A higher income than the going rate on good securities will almost always, sooner or later, result in a loss of principal greater than the extra income secured.

3. *The “put-them-away-and-forget-them” method*

The proponents of this method believe that it is impossible to foresee depressions or to foretell wide interest-rate fluctuations; that the best plan, therefore, is to buy good securities and hang on to them, up hill and down. The experience of investors who tried this plan during the 1929-1932 depression would seem to prove its fallaciousness. This is the plan advocated by Edgar Lawrence Smith in his popular book of the nineteen-twenties, entitled “Common Stocks as Long-Term Investments.”

4. *The “in-and-out-trading” method*

This method, which indeed cannot be called a method of *investment* management at all, I am sure I need not discuss. My remarks in Letter No. 3 on “Timing” I hope were adequate to discourage anyone from attempting so hazardous and unprofitable an undertaking.

5. *The “median line” method*

The advocates of this more or less mechanical method of investment management select a “median line” of the stock market average, such for instance as 150 (Dow-Jones Industrial Average).

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When the average is at 150, a fund, let us say of \$100,000, is invested 50 per cent in common stocks and 50 per cent in high-grade bonds—\$50,000 in each type of security. Should common stock prices rise \$10,000, to \$60,000, the fund would be considered "out of balance" because it held \$10,000 more stocks than bonds. Common stocks worth \$5,000 would then be sold and reinvested in bonds, leaving \$55,000 in each type of security. Should the stocks in the fund advance to the extent of another \$10,000, the same procedure would be followed, bringing the fund back to 50 per cent stocks and 50 per cent bonds each time.

Should stock prices decline, no change would be made until the "average" reached 150, when the opposite course would be followed. Every time the common stock portion of the fund *declined* \$10,000, five thousand dollars worth of *bonds* would be *sold*, and the proceeds invested in common stocks.

This method, on first thought, seems highly advantageous. As common stocks *rise*, you are selling them off—"freezing your profits," on the theory that "trees don't grow to the sky" and that the top must be reached sometime. As common stocks decline, you are buying them—"averaging down," on the theory that the farther prices fall, the more shares you will get for your money. Theoretically, by always buying *under* 150 of the Dow-Jones Industrial Average, and always selling *above* that figure, you will always sell at prices higher than you pay.

This method will work out that way, assuming that the stocks in the portfolio rise and fall in proportion to the

INVESTMENT MANAGEMENT METHODS

average, and that there is no loss in the bond element of the fund. It is surprising, however, that the appreciation derived from "always buying under 150, and always selling above that figure" is so remarkably small. The table on the next page illustrates the operation of a \$100,000 fund under this plan. Starting when the Dow-Jones Industrial Average is 150, it rises to 212, then declines to 120, and then advances to 150 again. Throughout this complete cycle, the gain on a \$100,000 fund is slightly more than \$3,000. (See table.)

This mechanical method has several advantages. It avoids in-and-out-trading. It caters to the inclination of many investors for a considerable degree of activity in their accounts. It permits the investment of the entire fund at all times in income-paying securities. And lastly, in a period of declining common stock prices, there is some comfort in the thought that the lower the level to which prices decline, the greater is the number of shares which can be purchased with a given amount of capital.

In this table it is assumed that the price of the common stocks held in the fund is the same as the Dow-Jones Industrial Average index number.

The "median line" method requires less ability in foreseeing economic trends than does the "major economic trend" method discussed below. Ordinary results should be materially improved by an organization which understands the characteristics of the various *industries*, the sequence in which their representative common stocks are likely to advance or decline, and the relative amplitude of their fluctuation.

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| | <i>Approx. Total Fund</i> | <i>Approx. Value of Bds.</i> | <i>Approx. Value of Stks.</i> | <i>Dow- Jones Ind. Av.</i> | <i>Approx. No. Shs. of Stk.</i> |
|---|-----------------------------------|--------------------------------------|---------------------------------------|------------------------------------|---|
| Dow-Jones Industrial | | | | | |
| Average at 150..... | 100M | 50M | 50M | 150 | 333 |
| Stocks rise \$10,000 (20%)..... | 110M | 50M | 60M | 180 | 333 |
| Sell \$5,000 of stocks (approx- imately 18 shs.) and buy bonds | 110M | 55M | 55M | 180 | 305 |
| Stocks rise \$10,000 (approx- imately 18%)..... | 120M | 55M | 65M | 212.4 | 305 |
| Sell \$5,000 of stocks (approx- imately 13 shs.) and buy bonds | 120M | 60M | 60M | 212.4 | 282 |
| Stocks decline to 150..... | 102M | 60M | 42M | 150 | 282 |
| Sell \$9,000 of bonds and buy stocks (60 shs.)..... | 102M | 51M | 51M | 150 | 342 |
| Stocks decline \$10,000 (approx- imately 10%)..... | 92M | 51M | 41M | 120 | 342 |
| Sell \$5,000 of bonds and buy stocks (approximately 41 shs.) | 92M | 46M | 46M | 120 | 383 |
| Stocks rise to 150..... | 103M | 46M | 57M | 150 | 383 |

This "median line" method of management should command a lower fee than the "major economic trend" method, as the results of the latter should be much more satisfactory—*under competent investment managers.*

6. *The "major economic trend" method*

Under this method, *if the managers are extremely competent*, investment management achieves its best results, but the managers *must be competent*, especially in foreseeing major economic trends.

The aim of this type of management, as its name implies, is to foresee major economic trends with a fair degree of accuracy—not perfectly, you understand, for that is impossible, but *with a fair degree of accuracy.*

For instance, in the illustration I have used to explain the "median line" method, let us suppose that economic

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conditions were exceptionally favorable at the inception of the period. Under such conditions it would be reasonable for a competent investment counsel to recommend, for a normal investment fund, the allocation of approximately 70 per cent of the fund to common stocks or other earnings-dependent securities. These, or other stocks, would be held until economic conditions seemed unfavorable. Let us assume that they were disposed of, either on the way up or on the way down, at prices averaging 170—allowing 20 per cent as a factor of error in the recognition of the turning point. This would have resulted in an appreciation of \$20 per share on 466 shares—approximately \$9,000.

Then let us assume that there was another factor of error of 20 per cent in recognizing the bottom of the decline before economic indications again became discernibly favorable. On this basis, 635 shares of stock could have been bought at prices averaging 144. When the Dow-Jones Industrial Average again reached 150, a further appreciation of \$6 per share would have been secured on 635 shares—approximately \$3,800. This amount, added to \$9,000, would total \$12,800—more than four times as great an appreciation as the \$3,000 secured by the “median line” method.

In my letter on “Results Achieved in the Past” (the second one after this) I shall give you the actual results achieved, over a seven-and-a-half-year period, by a competent firm of investment counselors who employ the “major economic trend” method. We shall then compare their results with those which would have been achieved by following the “median line” method.

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This letter I believe will give you a fairly good idea of the six methods of investment management. I believe you will agree with me that the choice of any thoughtful person will lie between No. 5 and No. 6. If you are inclined to be nervous about your investments or if you prefer a reasonably high income to a better opportunity for appreciation and less risk of loss, it would probably be well for you to decide on No. 5, the "median line" method. On the other hand, if your circumstances are such that your second objective (after safety of principal) is appreciation of capital, rather than income; and if you are not inclined to worry about your investments, then it would probably be wise for you to decide on No. 6, the "major economic trend" method—if you can find *competent* counsel.

We have now considered two of the four items, the investigation of which is necessary if you are to use a *logical* method in the selection of investment advisers.

We have considered the eleven types of investment advisers—from stock-and-bond salesmen to investment counsel—and you have, I presume, decided what type of adviser should serve you best.

We have examined the six methods of investment management, and you probably have also decided which method is best adapted to your own particular needs and preferences.

But don't think of making a decision yet. A *most important part* of our investigation lies ahead of us! Many an investor has made the mistake, after listening to the advantages

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of investment counsel over other types of advisers, and after hearing a description of methods said to be employed—has made the mistake of *assuming* that the title “investment counsel” plus the “methods employed” would produce good results. So hasty a conclusion is not warranted. There are two important matters yet to investigate—(1) the facilities of the advisory organization, and (2) the results they have achieved.

Those two subjects I shall discuss in my next two letters.

Very sincerely yours,

H. G. CARPENTER

Letter No. 9 . . .

FACILITIES AND ORGANIZATION

DEAR MR. SMITH:

Investment management, as you so properly concluded in your last letter, is an intensely difficult task. It is neither an art nor a science, but a combination of the two. It presents an ever-changing problem which can never be solved exactly. The investment manager can never be *sure* of anything, for he is always dealing with *probabilities*, rather than certainties. He must constantly be balancing the favorable probabilities against the *unfavorable*, and plan his program accordingly. With probabilities equally divided between the favorable and the *unfavorable*, he steers a middle course—recognizing and accepting the element of risk which is always present in greater or less degree. If the *favorable* probabilities begin to outweigh the *unfavorable*, he may accept greater risk in his quest for income and purchasing power preservation. But if the *unfavorable* probabilities seem to outweigh the favorable, he then must reduce the element of risk until the danger—whether it eventuates or not—is passed. There never has been, and never will be a period in which there is no risk in investment. That is particularly true in these days of social and political upheaval (1939) when the normal problem is multiplied by the danger of inflation and the possible loss of purchasing power.

FACILITIES AND ORGANIZATION

The facilities essential to the recognition of the frequently changing balance of probabilities should be an important consideration in selecting an investment counsel.

RESEARCH STAFF

The past must be studied, for the past, even though it will never provide an exact pattern for future occurrences, is the laboratory of the successful investment manager. A competent research staff is indispensable, not only for recording the economic happenings of the past, but for studying the tendencies of *industries* in their reaction to those economic happenings, all with the purpose of enabling the policy committee better to foresee the future.

STATISTICAL DEPARTMENT

Right hand to the research staff is the statistical department. A well-conducted investment advisory organization will keep up to date some two thousand indexes, portraying the trends of economic indicators, the behavior of *industries* and the current position of several hundred of the more important or more prosperous companies. A large percentage of these records are converted to chart form to enable the policy committee more easily to visualize the probable course of events and the relative advantages of two score *industries* and several hundred companies. A great many of these indexes must also be "corrected for seasonal variation," a laborious task demanding the services of an experienced statistical personnel.

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POLITICAL OBSERVERS

The facilities of a well-rounded investment advisory organization will also include political observers, both for Washington and abroad.

POLICY COMMITTEE

Keystone of the whole organization is the policy committee, which should be small, but made up of men of wide experience particularly in the field of determining major economic trends. The committee should have a dominating chairman—a man who will listen to the opinions of his associates, but who then has the courage to make the final decisions *and take action*. So long as he is acting in this capacity this man's word should be law, his decisions final. If for any reason he should be absent, if only for a temporary period of a few days, or a few weeks, one of the other members should be charged with this responsibility. Larger committees, or committees not dominated by one competent head, usually get nowhere. A defers to B, B to C, etc., with the result usually that nothing is done.

All of the work of the research staff, the statistical department and the political observers is made available to the members of the policy committee. Indeed, the work is done primarily *for* the policy committee. Possessed of all research, statistical and political data compiled by the three respective departments, and this supplemented by their own studies and observations, the policy committee, as the term implies,

FACILITIES AND ORGANIZATION

decides upon the general investment policies of the organization, chiefly:

1st—What percentage of earnings-dependent securities should be employed in the various classes of accounts—(1) aggressive, (2) normal and (3) conservative,

2nd—What percentage of the fixed-income securities (bonds and preferred stocks) held by clients should be of long maturity,

3rd—Which *industries* are in a more favorable position and which in a less.

SUPERVISORY PERSONNEL

It is obviously impossible, as well as unnecessary, for the policy committee to attend to all of the details of translating policies into specific recommendations for each account. This work is undertaken by the "supervisory personnel"—a group of men, each of whom attends to all *details* in connection with the several accounts allotted to him.

The account supervisor informs himself thoroughly regarding the circumstances, objectives and preferences of the clients whose accounts are under his supervision. All conclusions of the policy committee are made available to him, as well as the reports of the research staff, the statistical department and the political observers. He is the personal representative of the client in the advisory organization. While general recommendations for changes in the portfolios of clients are originated either by the policy commit-

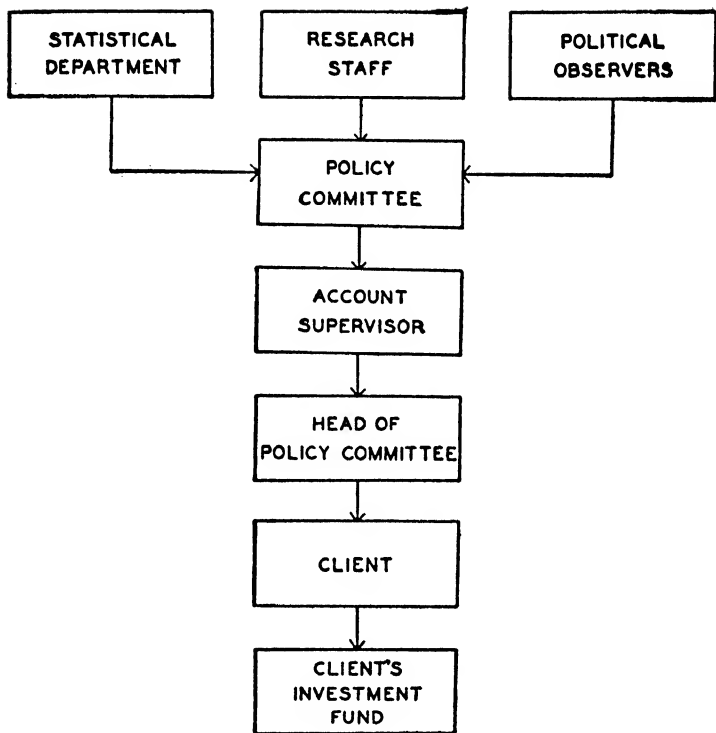
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tee, or the research staff or statistical department, the account supervisor is free to *make suggestions* regarding changes in the individual accounts under his supervision. *No recommendation of his, however, nor of the research staff or statistical department, for the account of any client, can be made to the client* until it has been approved by the head of the policy committee. (This direct control of accounts by the head of the policy committee is possible only to the organization with a reasonably moderate volume of capital under its direction. In large advisory organizations, greater authority must be extended to junior employees.)

Recommendations always go to clients as recommendations. That is, no change can be made in the client's account until he has approved of the recommendations of his investment counsel and transmitted the order to his broker or bank for execution. The client retains possession of his securities. No reputable investment counsel will accept custody of his clients' securities, under any consideration.

Such are the facilities and the organization of a well-conducted investment counsel firm. The chart on the next page will perhaps enable you better to visualize the flow of information and of recommendations through the several departments.

Upon rereading the above letter, it sounds rather convincing—as though such an organization, with such facilities, would certainly be competent investment advisers. But that does not necessarily follow. The same tale has been told a thousand times—and perhaps better told—by able salesmen of mediocre investment advisory organizations.



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That is where so many investors have fallen down in their investigation of investment advisers.

They hear the story of investment counsel and *assume* that *any* organization, freed from conflicting interests and bias, will prove to be competent.

They are told of management methods which are so obviously superior to their own that they *assume* that *any* organization which employs such methods must produce good results.

They listen to the story of facilities and organization and *assume* that *any* investment adviser with such facilities and such an organization *must* be competent.

It is true that the elimination of bias and conflicting interests is an important requisite to successful investment management. It is true that the methods employed are very essential to good results. And it is true that adequate facilities and a well-rounded organization are indispensable. But these three qualifications, important as they are, *do not prove ability*. Investment management is a difficult task. Success in the management of other people's money does not come to every man or organization that hangs out the "investment counsel" shingle. So many investors *assume* too much in their search for investment advisers. They do not follow through in their investigation. In my next letter I shall discuss "Results Achieved in the Past."

Very sincerely yours,
H. G. CARPENTER

RESULTS ACHIEVED IN THE PAST

DEAR MR. SMITH:

We now come to that most important of the four qualifications of an investment adviser—results achieved in the past.

In your search for investment advisers, you will find many who have little to say on the subject of results *they have achieved in the past*. Every effort is put forth to make it appear that they *ought* to be good *in the future*. You will meet various excuses, and objections to divulging results achieved *in the past*. (1) Some will tell you that they have kept no records. (2) Others will say that their advice has been good, but that it is often difficult to get their clients to follow it. (3) Still others will claim that the frequent withdrawals from, and additions to the accounts of their clients make it statistically impossible to keep an accurate record. (4) And still another group will tell you of the record of one or two or three accounts, but are silent on the rest.

All such objections and excuses would seem to be unfounded. (1) An investment advisory organization which “does not keep a record” of its results for clients is careless indeed, to say the least, for that is the one thing in which thinking investors are most interested. (2) The fact that some clients do not follow their investment counsel closely or quickly is a difficulty common to the profession. If results are lowered by this circumstance, it is just as great a handicap to one counsel as to another. (3) It *is* statistically possible

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to keep an accurate record of results, regardless of occasional withdrawals and additions to the accounts of clients, as I shall explain farther on in this letter. One might just as well maintain that it is impossible to compute the liquidating value of an investment trust because some of the shareholders had sold part of their holdings and others had increased theirs. (4) As to No. 4, if it is possible to keep a record of the results obtained for *some* clients, it obviously must be possible to keep such a record for *all* clients.

In my own investigation of this subject some years ago I ran across one organization, among others, which had recognized the fairness of the cautious investor's request for information regarding results achieved *for all clients throughout the entire time the advisory organization had been in business*. This organization reasoned as follows:

1. "The careful investor wants this information, and we believe he is entitled to it. Furthermore, we want it ourselves, for if it develops that we are not able to direct the investment of other people's money successfully, then we should get out of the business of investment counsel.
2. "We might keep an accurate record of the accounts of one, or two, or three of our first clients, but that has several obvious disadvantages.
 - a. "Some people might suspect that we favored those accounts at the expense of others.
 - b. "The clients might die or we might lose them for other reasons. Thus, the continuity of our record would be broken.

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- c. "In that event we *could* select other accounts which had been with us for a long time, but then the skeptical investor might suspect that we had selected the accounts with the best records and failed to mention the others.
3. "We could use the record of an investment trust we manage but that has the same disadvantage as 'a' above.
4. "What seems to be needed is a *composite* record, covering all accounts under our direction. And why not? That is exactly what an investment trust does. The investors who bought the first shares of the trust may die; any number of investors may have once owned the shares and later cashed them in; some investors may have cashed in part of their shares (equivalent to a 'withdrawal' of part of his fund by an investment counsel client); or others may have increased their original holdings (equivalent to making an 'addition' to the account under the direction of investment counsel).

"All of these changes may take place, but the current price of the shares of the investment trust, in comparison with the original price, accurately reflects the record of the fund.

"The accounting problem is not at all difficult, although the work does involve considerable expense. All we have to do is to think in the terms of the *shares* of an investment trust—only we will use the term 'unit.' Client No. 1 places his account under our

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direction—\$100,000 or 1,000 'units' of \$100 each. Before client No. 2, with \$100,000, comes in, our management has been successful in increasing account No. 1 to \$110,000. Each unit is therefore worth: $\$110,000 \div 1,000$, or \$110. The number of 'units' in account No. 2, therefore, is $\$100,000 \div 110$, or 909.1.

"Client No. 1 now has \$110,000 under our direction, and client No. 2 has \$100,000—a total of \$210,000. Client No. 1 has 1,000 units, and client No. 2 has 909.1—a total of 1909.10 units. Proof: $\$210,000 \div 1909.1$ equals 110.

"A little later client No. 3 places his account of \$200,000 under our direction. By that time, let us say, the \$210,000 under our direction has declined to \$205,000. The 1909.1 units are each worth: $\$205,000 \div 1909.1$, or 107.33. To determine the number of units represented by No. 3's \$200,000, we divide \$200,000 by 107.33. No. 3 has 1863.41 units and we now have \$405,000 under our direction, represented by 3772.51 units.

"As more accounts come in we make the same calculations—always the number of dollars under our direction and the number of units they represent. Now client No. 1 may leave us if he wants to. His loss will have no effect on our record of results. We merely deduct the dollar amount of his fund from the total *amount* under our direction, and deduct the number of units which his account represents from the total

RESULTS ACHIEVED IN THE PAST

number of *units* under our direction. His results, while his account was under our direction, are a part of our *composite record*, even though he has left us. In the same way the additions any client may make to his account, or the withdrawals he may take away, may be recorded. The value of the units tells the true story of our success in directing the investment accounts of *all* of our clients."

In actual practice it is neither practicable nor necessary to make the "units" calculation *every* time *any* change is made in the amount of capital under the direction of an investment counsel. It is customary to make the calculation only once every three months, and to take into consideration only the capital which has been under the counsel's direction for the entire three-month period. This method might be disadvantageous to the investment counsel's record during one quarter, and advantageous during another. In the long run the average will be accurate enough for all practical purposes.

The results obtained for each client's account are confirmed each quarter by the client, no account being included which has not thus been confirmed. To guard against errors, the whole accounting is then audited by a firm of certified public accountants.

I hope I have not taxed your patience too much, Mr. Smith, with this long explanation of how the composite results of an investment counsel's work may be measured. You may be assured that I would not have done so did I not consider

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it of greatest importance to go into this subject of "results achieved" thoroughly.

There is so much evasion when it comes to the question of results achieved and so much reluctance in many quarters to adopt the composite record idea, that I want you to understand thoroughly why the *composite record* is so important—to you or to any other investor who is seeking *competent* investment counsel. For instance, suppose you and I were to start in the investment counsel business, and suppose, too, that neither one of us knew much about the most important part of the investment management—foreseeing major economic trends. Here is one way we *could* operate and always, no matter what happened, be able to disclose a good record. We could manage *half* the accounts under our direction cautiously—a large percentage of high-grade, short-term bonds, and only the strongest stocks in stable-earnings industries. The other half, we could direct aggressively—a large percentage of stocks with highly cyclical earnings. Then, a few years later, if we had been passing through a period favorable to an *aggressive* policy, we could disclose the excellent record of some or all of our aggressively-managed accounts. On the other hand, if the period had been one favorable to a *cautious* policy, we could disclose the record of our accounts devoted largely to high-grade bonds. No matter what happened, we could show a good record—if we could convince investors by disclosing the results of only *part* of our accounts, for relatively short periods.

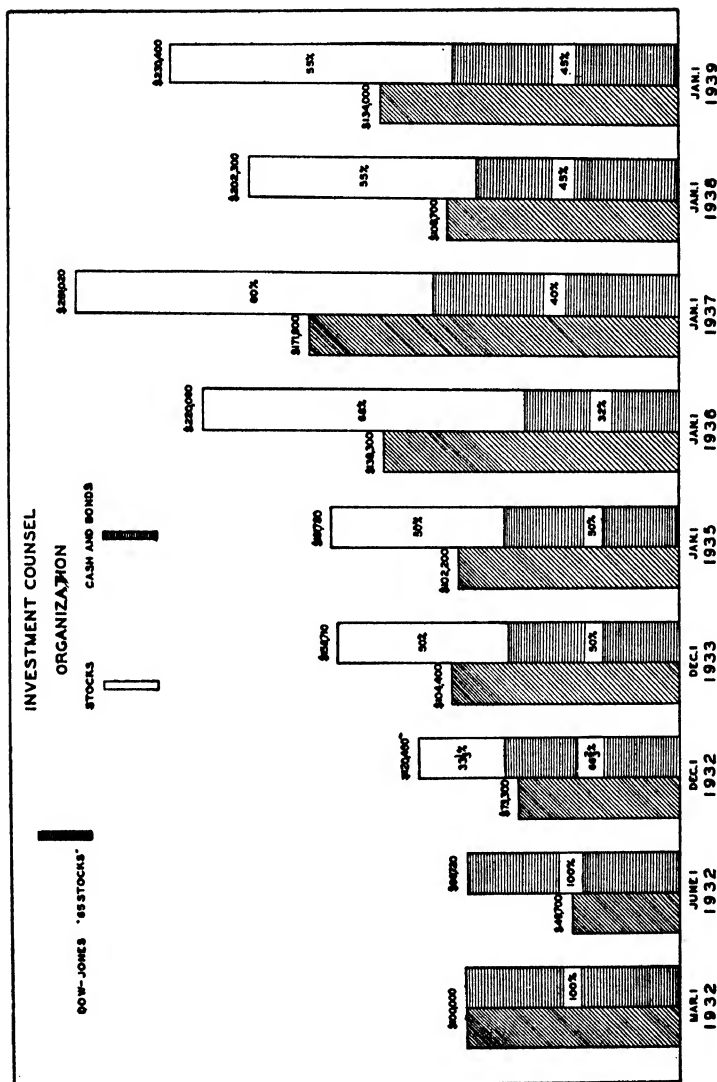
RESULTS ACHIEVED IN THE PAST

In this connection, I am reminded of an investor with whom I was discussing "results achieved in the past." The year preceding our conversation had been a most difficult one. When I asked him how successful he had been during that difficult period, he pulled open the upper left-hand drawer of his desk and handed me a list of high-grade bonds. The list had suffered practically no decline during the preceding year. I congratulated him on his good judgment in employing no earnings-dependent securities during a bad period. "Oh, but I did," he replied, and pulling open the *right*-hand drawer, he handed me his list of common stocks, which had suffered a bad decline. The *high-grade bond* list was the "cautious" part of his account. *Its* record during a difficult period was no more indication of his investment management ability than is the record of a *single*, or *several*, accounts directed by an investment advisory organization.

The only thoroughly accurate test of investment management ability is the composite record of results achieved for *all accounts* under the investment advisory organization's direction, *for the entire period through which it has been in business.*

The record of the investment counsel organization referred to above—from the time the first account was placed under its direction on March 1, 1932, up to January 1, 1939—is pictured in the chart on the following page. Note particularly:

1. That the composite record of this investment counsel organization (for the six-year-and-ten-month period



RESULTS ACHIEVED IN THE PAST

—including two drastic declines in common stock values) has surpassed the Dow-Jones “65 Stocks” average by a very considerable margin;

2. That in spite of the longer-term excellent record of the organization, there were shorter periods during which rather substantial declines were recorded. For example, the average account placed under the direction of this firm at the end of 1936 would have shown a decline of 28 per cent by the end of 1937. Such a decline might be very disturbing to the investor who does not appreciate the difficulties of investment management, and who does not realize that such unfortunate circumstances are occasionally unavoidable.

Were it possible to conduct an investment management program without any mistakes, capital could be increased at a tremendous rate. One statistician has calculated, for instance, that an errorless record from 1897 to 1934 would have increased \$1.00 to \$238,255,475,869. Such staggering figures serve only as convincing proof that occasional mistakes in investment management, like occasional mistakes in any other business or profession, are impossible to avoid. *No* reputable investment counsel will pretend that his organization can avoid the occasional misinterpretation of economic phenomena, or that his conclusions regarding the future of an industry may not occasionally be wrong, or that his judgment

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regarding the relative merit of individual companies may not fall down occasionally.

The important thing is for them to be right oftener than they are wrong. That is the most that can or should be expected. That is why it is so vitally important to know what has been the longer-term composite record of all accounts under the direction of an investment counsel organization.

The record referred to in the chart on page 76 was achieved by the "major economic trend" method of investment management. It will be interesting to compare that record with the results which would have been achieved by the "median line" method. The table on the following page shows what the "median line" method would have accomplished during the same period, assuming that the common stocks employed would have fluctuated on a parity with the Dow-Jones Industrial Average, and that no losses were suffered in the bond elements of the fund. I have used a \$100,000 fund, beginning on March 1, 1932, for illustration, just as I did in my explanation of the "median line" method in Letter No. 8.

Note that the "median line" method would have produced a theoretical appreciation of 59 per cent during the six-year-and-ten-month period, while the actual composite appreciation of the "major economic trend" method, *as interpreted and applied by the organization referred to above*, produced an appreciation of 134 per cent during the same period.

RESULTS ACHIEVED IN THE PAST

| | <i>Total Fund</i> | <i>Bonds</i> | <i>Stocks</i> | <i>Approx. Dow-Jones Average</i> | <i>Approx. No. Shs. of Stock.</i> |
|--|-----------------------|--------------|---------------|--|---|
| A \$100M fund on March 1, 1932. Dow-Jones Industrial Average at 80..... | 100M | 50M | 50M | 80 | 635 |
| Common stocks decline \$10M to \$40M (20%)..... | 90M | 50M | 40M | 64 | 635 |
| Sell \$5M of bonds and buy stocks (approximately 78 shs.).... | 90M | 45M | 45M | 64 | 703 |
| Common stocks decline \$10M to \$35M (approximately 22%)... | 80M | 45M | 35M | 50 | 703 |
| Sell \$5M of bonds and buy stocks (approximately 100 shs.)... | 80M | 40M | 40M | 50 | 803 |
| The Dow-Jones Industrial Average declined to approximately 40 by July 1932, but as this was not enough to bring about a decline of \$10M in the stock portion of the fund, no further purchases of common stocks would have been made. | | | | | |
| Common stocks rise to 150—Dow-Jones Industrial Average... .. | 160M | 40M | 120M | 150 | 803 |
| Sell \$40M stocks (approximately 267 shs.) and buy bonds..... | 160M | 80M | 80M | 150 | 536 |
| Common stocks rise \$10M to \$90M (approximately 12%)..... | 170M | 80M | 90M | 168 | 536 |
| Sell \$5M stocks (approximately 30 shs.) and buy bonds..... | 170M | 85M | 85M | 168 | 506 |
| Common stocks rise \$10M to \$95M (approximately 12%)..... | 180M | 85M | 95M | 188 | 506 |
| Sell \$5M stocks (approximately 27 shs.) and buy bonds..... | 180M | 90M | 90M | 188 | 479 |
| The Dow-Jones Industrial Average rose to 195 in March 1937, but this was not enough to bring about a further rise of \$10M in stocks, so no further sales were made. | | | | | |
| Common stocks decline to 150—Dow-Jones Industrial Average | 162M | 90M | 72M | 150 | 479 |
| Sell \$9M bonds and buy stocks (approximately 33 shs.)..... | 162M | 81M | 81M | 150 | 512 |
| Common stocks decline \$10M to \$71M (approximately 12%).. | 152M | 81M | 71M | 132 | 512 |
| Sell \$5M bonds and buy stocks (approximately 38 shs.)..... | 152M | 76M | 76M | 132 | 550 |
| Common stocks rise to 150—Dow-Jones Industrial Average... | 159M | 76M | 83M | 150 | 550 |

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I want to emphasize, *particularly*, the two important requirements in the "composite record" presentation of "results achieved in the past."

You have perhaps noted my use, several times, of the phrase "for the *entire* period through which the investment advisory organization has been in business." There is a very natural tendency on the part of *anyone*, in *any* line of endeavor, to point with pride to his successes, and neglect to mention his delinquencies. One must not, therefore, attempt to judge an investment adviser by his successes only, for that would result in an unduly optimistic representation of his capacity. Ability is *not* evidenced by the appreciation secured in a single period of rising security prices, nor by the capital conserved in a single period of declining values. Investment management is a long, arduous struggle to conserve capital and preserve purchasing power *over a term of years*. The period by which an adviser is to be judged, therefore, should be as long as possible—"throughout the entire period in which he has been in business." Only by insisting upon the record of results *throughout the entire period*, will the inquiring investor command a view of the prospective adviser's delinquencies as well as his successes.

For the same reason (to command a view of the prospective adviser's delinquencies as well as his successes) it is equally important that the record of *all accounts* under his direction be considered.

RESULTS ACHIEVED IN THE PAST

To arrive at a cold, logical, impartial appraisal of ability, one must know the composite results achieved "for *all accounts* under the adviser's direction, for the *entire period* through which the organization has been in business."

In closing this letter, let me again call to your attention that it was not merely the use of the "major economic trend" method which produced such satisfactory results. It was the ability of the investment counsel in *applying* that method. I have no doubt that many another less able investment adviser, who professed to use the same methods, was unable to achieve anywhere near as satisfactory results. A statement of "methods employed" must always be backed up by proof of ability *to apply those methods*.

On the following page is a guide to the selection of competent investment advisers.

Very sincerely yours,
H. G. CARPENTER

THE LETTERS OF AN INVESTMENT COUNSEL

A GUIDE TO THE SELECTION OF COMPETENT INVESTMENT ADVISERS

A. What general source or institution does the organization represent:

1. An investment banker?
2. An investment dealer?
3. A broker?
4. A stock-and-bond salesman?
5. A broker's "customers' representative"?
6. A commercial bank?
7. A trust company?
8. A statistical organization?
9. A financial journal?
10. A bulletin service or "service"?
11. An investment counsel organization?

B. What method of management do they employ:

1. "Individual security" method?
2. "Invest-for-high-income" method?
3. "Put-them-away-and-forget-them" method?
4. "In-and-out-trading" method?
5. "Median line" method?
6. "Major economic trend" method?

C. What facilities do they have:

1. Number of employees?
2. Number of sources of information?
3. Number of indexes maintained?
4. Number of accounts managed?
5. Total volume of capital managed?

D. Organization:

1. Who heads the organization?
2. Who comprise the policy committee?
3. Background and experience of these people?
4. Number and qualifications of research personnel?
5. How does advice get to *you*?
6. Is the organization so large that too much authority must be delegated to juniors; or so small that adequate facilities are not available?

E. Proof of results achieved in the past:

1. No proof?
2. Miscellaneous pronouncements?
3. Record of a few selected accounts? Or of an investment trust?
4. Composite record of *all* accounts for the *entire time the organization has been in business*.

By checking the status of your present investment advisers in the above table, you will account for the results you have achieved, whether good, mediocre or unsatisfactory.

Series III

TRUE CONSERVATISM VS. CONVENTIONAL
CONSERVATISM IN THE MANAGEMENT
OF INVESTMENTS

Letter No. II . . .

INVESTING FOR A HIGH INCOME

DEAR MR. SMITH:

Now that we have finished the subject of "investment advisers," we can, one at a time, take up some of the things "*not* to do" to which I referred in my Letter No. 7.

The first subject to present itself under the head of "What *not* to do" is that of investing for a high income. The list you have sent me obviously has been selected largely with that objective in mind. On the other hand the "statement of your circumstances, objectives and preferences" does not indicate that you are in particular need of a large income from your investments. Let us think about this investing for a high income for a few minutes.

The income to be derived from high-grade investment securities varies with the general level of interest rates. Interest rates on high-grade securities, *at different times*, range roughly from 2 per cent to 6 per cent, depending upon a number of causes, but chiefly upon the demand for loans by business institutions. When that demand is strong enough, the yield from high-grade securities may be as much as 6 per cent, and sometimes even more, but when there is a greater supply of loanable capital than there is demand for it, the income from high-grade securities will decline.

No matter what the income obtainable from *high-grade* securities, there are always other securities of *lower grade* on the market which will, temporarily at least, yield a larger

THE LETTERS OF AN INVESTMENT COUNSEL

income. The danger in investing in those lower-grade issues is that they may reduce the amount they are currently paying, or cease paying altogether. Furthermore, their value may decline drastically. The investor who seeks 5 or 6 per cent *at a time when high-grade securities are yielding but 3* must realize that he is taking a great deal of risk. A swimming pool affords a good analogy. With six feet of water in it, an experienced swimmer may dive with comparative safety. But with only three feet, the diver will probably bump his head on the bottom, and perhaps break his neck.

There seems, however, to be a general belief on the part of investors that investing for income is the conservative thing to do. When asked for reasons for this belief, I presume that no less than a score of these conventionally conservative investors have told me that their conservative fathers had admonished them always to invest for income. Perhaps that is the source of this misconception. It is not difficult to imagine many of our fathers advising investment for income. Their investments were largely in local properties on which taxes had to be paid and they wanted income at least to cover the taxes. I can distinctly recall in my early youth the concern of my father and mother over a non-income-paying farm which was being "eaten up by taxes." Whether or not this was the inception of the "always invest for income" error, it might be well to recognize that today there is, as yet, no tax on the *possession* of bonds and stocks in this country except a fairly nominal "monies and credits" tax in a relatively few states.

"I have \$100,000," said the *conventionally* conservative

INVESTING FOR A HIGH INCOME

investor in 1929; "I need \$5,000 per year for living expenses; therefore, I must invest for a 5 per cent income." "Surely that is conservative," he probably added. His plan was conventional—but hardly conservative, as many conventionally conservative investors found to their sorrow from 1929 to 1932. Many 5 per cent mortgages, which seemed strong in 1929, have long since defaulted. The mortgagee, in many instances, has been able to realize only a portion of his principal. Five per cent bonds by the dozen have defaulted, with the same results to investors. Many, indeed most stocks, which yielded even less than 5 per cent in 1928 and 1929, by 1932 had fallen to a fraction of their 1928 and 1929 prices. Many of them, too, reduced or passed their dividends. Many of them will never rise or pay again. Clearly it did not pay to "invest for income" during the 1929-1932 depression. The investor who did "invest for income" in almost every case lost more in principal than he gained in income—and dollars of principal, anyone will agree, are just as valuable as income dollars. Yet the conventional procedure was to "invest for income."

During the 1932-1937 recovery years we saw somewhat the reverse of the above situation. The *conventionally* conservative investor, not yet recovered from the fear inspired by "investing-for-income" losses during the depression, again cautiously (?) "invested for income." The truly conservative investor, on the other hand, recognized those recovery years for what they were—one of the rare periods in which appreciation, with comparatively little risk, might be sought in properly selected securities. This truly conservative in-

THE LETTERS OF AN INVESTMENT COUNSEL

vestor, however, again chose to forego temporary income. With his knowledge of *industries*, he selected among his other investments a reasonable percentage of the common stocks of companies in the cyclical industries. These brought him an *appreciation in principal* several times as great as the *income* he had to forego. (As I said before, a dollar of principal is just as good a dollar as a dollar of income.) Thus it is seen that this income misconception is a two-edged sword. It causes losses in a period of depression such as 1929-1932, and hinders appreciation in a recovery period, such as 1932-1937.

Wherein lies the difference between the *conventionally* conservative investor and the *truly* conservative in their approach to the income problem? The answer is that the *conventionally* conservative investor *seeks* income for income's sake, while the *truly* conservative investor considers income simply as a by-product of truly conservative, cautious investment management. The seeker of income *in periods of depression* almost inevitably loses some of his principal. Then he is tempted to seek a greater percentage of income. And the more income he seeks, the greater must be the risk he assumes, and the greater will be the losses he sustains. *In periods of recovery and prosperity* he seeks income and is therefore handicapped in achieving a reasonable degree of appreciation. The truly conservative investor, on the other hand, viewing income purely as a by-product of careful management, is free to conserve his principal in depression years and to seek a reasonable appreciation in periods of recovery and prosperity. In the long run he gets more in-

INVESTING FOR A HIGH INCOME

come, paradoxical as it may sound, *because he does not seek it.*

But, you may inquire, what if one actually *needs* the larger income to live on? Within reason, this need not alter the truly conservative investment policy. Consider the 1929-1937 investment cycle. Suppose an investor had \$200,000 in 1929 and needed \$10,000 a year for living expenses. That would be five per cent. *Let this investor take from his principal whatever he lacks in income earned by his investments.* Suppose this *truly* conservative investor had received only 2 per cent per year on his investments during the 1929-1932 period. He would have had to use 3 per cent per year, or 9 per cent of this principal, during those three depression years. Show me an investor who sought 5 per cent from 1929 to 1932 who did not lose more than 9 per cent of his principal! From 1932 to 1937, during a period of extremely low interest rates, let us assume that truly conservative methods produced, in income from investments, only 3 per cent per year. That would have meant 2 per cent more per year taken from principal, for five years, or an additional 10 per cent—a total from 1929 to 1937 of 19 per cent. Scores of investment accounts, managed on the *truly* conservative basis, came to my attention between 1932 and 1937, and there was not a single one which had not appreciated more than 19 per cent during that period. Indeed many truly conservatively managed funds advanced several times that percentage. The truly conservative, competent investment manager had more capital in 1937 than he had in 1929;

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the conventionally conservative income seeker, in most instances, had less.

Many an investor, who looks askance at the above plan, has bought an annuity which he classifies among his safest investments, if not *the* safest. An annuity does exactly the same thing I have outlined above. It uses part of the principal each year. But with an annuity the possibility of enhancement of principal is eliminated. The annuitant is *sure* that his principal will be dissipated.

Seeking income "because I must never use any of my principal" is undoubtedly one of the outstanding misconceptions of the *conventionally* conservative investor. It must not, however, be presumed that discontinuing the seeking of income will, in itself, make a competent investor out of an untrained, inexperienced one. The important difference between conventional and truly conservative investors lies in the realization by the latter (1) that there are long up and down trends in security values (alternate periods of depression and prosperity) and (2) that varying percentages of the three general types of securities must be employed at different times in those long trends, *regardless of the income earned*. Those two things must be understood if serious losses are to be avoided in bad times and a reasonable appreciation secured in favorable periods. Once the investor realizes that this is the most important phase of investment management, he has taken a long step toward becoming a *truly* conservative, instead of a *conventionally* conservative, investor. Then, and not until then, does he realize that seeking income *year*

INVESTING FOR A HIGH INCOME

in and year out, far from being conservative, is really a dangerous procedure.

In setting up your account we would very much like to reduce your income to a level more in line *with the current return* on high-grade securities. This for three reasons:

1. We believe that by so doing we can substantially reduce the risk you are now assuming.
2. We believe, also, that if we do not have to look for so large an income, we can recommend several low-dividend or non-dividend-paying common stock issues which seem to afford an excellent opportunity for appreciation during the next several years.
3. We believe that by taking this action at this time your fund will eventually afford you an even larger income than you are now receiving.

We do not want to take this step without your approval, because after all it is your money and we *can*, if you insist, set up your account with about the same income you are now getting, and still improve both the safety and appreciation probabilities to some extent.

Won't you please write us on this subject at your first convenience, so that we can proceed with our review of your fund.

Very sincerely yours,
H. G. CARPENTER

FIVE-YEAR EARNINGS

DEAR MR. SMITH:

Thank you indeed for your letter of the twelfth in which you express your approval of our suggestion that the income from your investment fund be reduced to some extent. I felt sure you would see it that way if a summary of all of the advantages was placed before you.

There are several other matters suggested in your letter which I believe we should discuss, toward the end of a complete understanding between us. You mention your strong preference for certain issues and refer (1) to their strong earnings over the past five years, and (2) to the information you have about them from inside sources. In this letter I want to talk about the subject "five-year earnings."

I presume if you were to ask the next ten investors you meet how they judge the merit of an investment security, at least nine of them would name "five-year earnings" as their first measuring device.

They do this because they have been taught to do it that way by security salesmen, investment dealers and investment bankers who have sold them securities. But what the security salesman may have neglected to tell them (if indeed he understood it himself) is that five-year earnings are important when judging the securities of certain *industries*, and relatively unimportant when judging those of others. "Five-year earnings" is the easy, conventional approach. The truly conservative investor will dig much deeper.

FIVE-YEAR EARNINGS

Suggest the common stock of United States Steel Corporation to the conventionally conservative investor at \$30 a share in 1935 and he will tell you that "it wouldn't be conservative." Ask him why not, and he will point to the absence of earnings during the previous five years. Suggest railroad bonds or stocks in 1934 and he will have the same answer. Advise him to sell American Can common stock in 1935 and buy Kennecott Copper and he will prefer the former because of good "five-year earnings." Offer him a lumber or a paper company bond in 1928, and he would have bought it because of good "five-year earnings."

Let us review for a moment.

True enough, United States Steel Corporation had no earnings for five years prior to 1935. But the truly conservative investor will not disregard the fact that the company is a representative of a highly cyclical industry; that it *always loses* money in periods of depression, and always just as surely makes generous profits in periods of prosperity. In fact, does it not stand to reason that when the United States Steel Corporation has just had five years of good earnings, as in 1929, it is likely to be nearing a depression period and is therefore a risky investment? Does it not also follow that when it has had five years of *poor* earnings, it may be nearing a period of business revival when earnings will improve? In other words, is not the conventional "five-year earnings" rule, *when applied to the steel industry*, really speculative instead of conservative? Convention says, in effect, that it is conservative to buy U. S. Steel at \$200 per share, but speculative to buy it at \$40.

The same fallacious argument applies to the railroads,

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another cyclical industry. The *conventionally* conservative investor could easily reason that they are speculative at \$20, \$30, and \$40 per share, but that they would be conservative at \$150.

In June of 1935 the common stock of American Can Company, a representative of the stable-earning food container industry with good five-year earnings, was selling at \$132 per share; Kennecott Copper, typical of a cyclical industry, with poor five-year earnings, at \$19. Two years later American Can had declined 26 per cent, while Kennecott had risen 131 per cent—another example of the fallacy of attempting to judge the value of securities by their five-year earnings.

The "five-year earnings" misconception applies to bonds as well as to stocks. In 1928 and 1929 the investment market was flooded with new issues of lumber company and paper company bonds. "Five-year earnings" *had been* splendid—but most of the issues were in default two or three years later. "Five-year earnings," as a test of investment merit, had failed again. All of which would seem to substantiate the thought that many an investor, though believing himself conservative, is, as a matter of fact, merely conventional. He does not understand the true principles which underly conservative investment.

What does all of the above signify? It signifies very clearly that many investors are ignoring two of the *most important* steps in the management of money, while assigning altogether too much importance to a minor consideration. They are ignoring the behavior of industries (steel, foods, copper, etc.) and are ascribing too much importance to "five-year

FIVE-YEAR EARNINGS

earnings." They are ignoring the broad, important, economic factor and are paying too much attention to the relatively unimportant, statistical factor. *Future* earnings are important, all important, in the selection of securities. But *past* earnings—except as they may be indicative of the future—can be very misleading. The important question is: What are earnings *going* to be? And to gauge future earnings with any degree of success, one must first consider the economic characteristics of the period, and then know what industries are well adapted to such characteristics.

The chief reason why competent investment managers pay little attention to the "ratings" of the statistical organizations is that such ratings largely reflect the past. That a bond or stock is rated "A" chiefly because of past earnings, is no guarantee that earnings will continue to be good. The "ratings" follow the earnings down. Likewise, a "B" rating today, especially in the case of securities of cyclical industries, affords no assurance that the affairs of the company are not improving. In that case the "rating" follows the earnings *up*. "Five-year earnings," at best is a rule-of-thumb measure, affording but little insight into the merit of an investment security.

With the two companies you mentioned in your letter, we would say that one is in a favorable position, but that the other is not. In the case of the latter, while its past five-year earnings have been good, we look for poorer earnings sometime in the reasonably near future. The company distributes a number of brands of package goods on which the price is pretty well established. If the rise in commodity prices, which

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we expect, takes place, this company will have to pay more for its raw materials, but cannot very well raise the established prices of its package goods. We may be wrong in our expectation of rising commodity prices over the years ahead, but if we are right in that respect, the past experience in that industry indicates very clearly that earnings will be poorer during the next five years than they have been during the last.

In view of these circumstances, we hope you will revise your earlier judgment and follow the recommendation we are going to make for replacing that particular issue with one which has had equally good earnings during the last five years, but which will not carry the same handicap during the period ahead.

Very sincerely yours,
H. G. CARPENTER

Letter No. 13 . . .

INSIDE INFORMATION

DEAR MR. SMITH:

In my last letter, on "Five-Year Earnings," I referred to a second subject you had mentioned which I wanted to discuss with you—"information from inside sources."

According to *TIME* of September 18, 1939, it was "Joe" Kennedy, our present ambassador to England (himself noted as a successful Wall Street operator), who said: "Given enough money and plenty of inside information, anybody can lose his shirt on Wall Street."

Your case may be the exception which proves the rule this time, but generally—almost always—Mr. Kennedy's advice is very sound.

It is an alluring picture. Mr. Brown, the great banker or industrialist, is on many directorates. What is more plausible than that so and so (a broker or an investment banker or an investment counsel) knows Mr. Brown "personally" and that Mr. Brown says this or that. But let us not be too naïve. Let us examine the common sense of this business. I want to tell you a few true stories about "inside information."

INSIDE INFORMATION FROM JAMES WHITE

I ride into town every day with James White. He is a vice president and director of one of America's great corporations. We visit together, go to the same church and our children are friendly and go to the same school. One day, while

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we were talking on the train, Mr. White said to me, "Why don't you ever come up to the office to see us?"

I thought I knew what was coming and after waiting a few seconds, I replied, "What for?"

"Well, I don't know," he answered. "A good many people do, particularly the investigators for statistical organizations and investment counsel. They are looking for information about the company. In fact, it is beginning to take so much of my time that I guess I shall have to call at least a partial halt to it."

"Mr. White," I said to him, "I want to tell you why I don't ask you any questions about your company. If I came to you and asked you to give me a thousand dollars I feel quite sure you would refuse me. I don't see any more reason why I should expect you to give me inside information about your company, which might be worth a thousand dollars or perhaps more to me. I assume that you occupy a position of trust as a director and officer of your company, and that any inside information you may have, belongs first to your board of directors and second to your stockholders."

"You are quite right," he replied, "and I can give you my word that I have never divulged one bit of information to those investigators that they could not just as well have found in our published reports."

INSIDE INFORMATION FROM "UNCLE BERT"

Into my office one day came a young man from the Middle West, accompanied by his uncle whose name I did not hear distinctly when introductions were made. During our con-

INSIDE INFORMATION

versation the question of inside information came up and I had expressed my opinion as to its general worthlessness. "What do you say to that, Uncle Bert?" the young man asked. And then I learned that the older man was one of the executives of a corporation which is almost a household word in America. "Well," said Uncle Bert, "I guess I'd answer questions pretty straight while business was forging ahead, but I'd have to be rather cautious if it were going the other way. You see," he continued, "associates of mine who are my best friends own a great deal of our stock, as of course I do myself. And then, too, it would hardly be fair to our general list of stockholders to divulge unfavorable information to the investment advisers of the holders, let us say, of one hundred thousand shares of our stock. They might sell out and depress the price for all the rest of our stockholders—including me," he added with a chuckle.

"Uncle Bert," it seems to me, had just the right idea. When the giving out of "inside information" will have a tendency to boost the price of their securities, corporate officials and directors may ladle it out with a free hand. But when it is time to be cautious, either they will be reticent about making any statement or they will follow the old adage my mother used to quote to me: "Answer a fool according to his folly." "Uncle Bert's" reaction may possibly be a shock to naïve people who expect something (including valuable information) for nothing. But to me, he was talking plain, everyday, common horse sense. Certainly the investor or broker or investment banker or investment counsel who gets his information that way is going to be fooled

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at least part of the time—probably enough so that his net results will be mediocre.

There is, however, another angle to this inside information question. The average corporation executive, outside of the bias he may and ought to have, frequently sees only the current *statistical* picture of his company. I know of many instances where their investment judgment has been very poor, both in periods of depression and periods of recovery.

1931 INSIDE INFORMATION FROM A RAILROAD OFFICIAL

In April, 1931, I had lunch with a railroad official. The common stock of his company had then fallen from a 1929 high of \$125 per share to approximately \$60. He told me the stock was a "gift" at that price, that it was earning over \$7 per share and that it couldn't help going up. I am sure this man was honest with me. I have known him from boyhood and I believe that, if he had realized the true situation of the railroad *industry*, he would at least have told me that he preferred not to discuss the matter. Whichever was the case, the stock continued to decline steadily, discontinued its dividend entirely, and by mid-1932 was selling for less than \$10 per share.

1935 INSIDE INFORMATION FROM AN OFFICER OF A LOCOMOTIVE COMPANY

This man, not having been very successful with his investments, was investigating investment advisers. He was beginning to like the looks of a certain investment counsel organization when the counsel's representative told him that

INSIDE INFORMATION

they were then recommending his own company's stock. "You must be crazy," said the locomotive company official. "We haven't made a dollar in five years and it looks as though we never would. I don't want to retain any investment counsel who is recommending our stock." The counsel failed to get the account, but the stock of the locomotive company more than quadrupled in value during the following two years.

The above and many other similar experiences have led me to the following general conclusions regarding investors or *investment advisers* who take "inside information" too seriously.

1. They disregard the circumstance that, except in rare instances, the only corporate officials and directors who could be safely believed are the ones *who will not divulge* information which has come to them in confidence; and that the pronouncements of the others are just as likely to be misleading as helpful.
2. They ignore the certainty that the purveyors of inside information usually have personal interests in direct conflict with the interests of those to whom they pretend to give inside information.
3. They do not appreciate that corporation executives, though ever so successful in the business management of their own concerns, frequently either under-value or overvalue the *investment* significance of happenings within their own companies.
4. And lastly, they frequently do not realize that the

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statistical type of information which they may obtain directly or indirectly from "insiders" may be of relatively little significance in carrying on a successful investment management program.

I don't want to go so far as actually to scoff at all inside information, but I am very skeptical of it as a rule. Here at this office we have found it to be so generally inaccurate that we pay no attention to it whatsoever. It might *sound* fine to some people for us to tell of our acquaintance with "Mr. White" and other nationally known names (some investment advisers do) but really, Mr. Smith, things don't work that way, at least here in New York, the "inside information center of the world." The rule in New York, as I heard it expressed recently, is "nothin' for nothin'." Your source of information may be a good one, and we shall of course be guided by your desires in this instance; but I want to have you know just how we feel about "inside information" generally.

Most sincerely yours,
H. G. CARPENTER

Letter No. 14 . . .

CAPITAL CONSERVATION AND PURCHASING POWER PRESERVATION

DEAR MR. SMITH:

In your last letter you made some reference to earnings-dependent securities which leads me to believe that you are thinking more in terms of appreciation than of purchasing power preservation. Heretofore, in my letters to you, I have made some reference to purchasing power preservation, but perhaps you will bear with me if I go into the matter a little more thoroughly at this time.

The chief aim of investment management is, and should be, capital conservation. After that, *under normal circumstances*, comes income. Third, *under normal circumstances*, would come the attempt to obtain a reasonable degree of appreciation.

Today, however, it is more necessary than it has been at any other time for sixty years to think of the appreciation objective, for it is only through appreciation that one can attempt to preserve the purchasing power of his capital. The conventionally conservative investor sometimes misinterprets the *motive* of a program which seeks appreciation—sees it as “speculation,” rather than as purchasing power preservation. He will tell you that the sole aims of conservatism should be to conserve capital and to produce a reasonable income. That answer would be *entirely* proper if the investor were a bank or a life insurance company, but it is not the

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correct answer for the average reader of this page who, it is assumed, is an individual investor. At least, it is not the completely correct answer.

There are thousands of investors in the United States today who are beginning to realize that capital conservation alone, in view of current economic conditions, is not the answer to their investment problem. They are the men and women of the "rentier" class—those who rely upon income from their investments for their living expenses. This class of investors, particularly those who have just about enough income to pay expenses, have noted two insidious developments:

1. Their income has been *decreasing*, and
2. Their expenses have been *increasing*.

Cheap money, the decline in interest rates, has been the cause of their decreasing income. High-grade bonds which paid 5 per cent have matured, or have been called and refunded at 4 per cent, 3½ per cent, and even 3 per cent. The same trend has been evident in preferred stocks, savings bank deposits and mortgages. A given amount of capital does not now yield the same return that it did several years ago. The downward trend of interest rates, while welcomed by the government, and other big borrowers with adequate collateral, has reduced income for the *conventionally* conservative investor. On the other hand, commodity prices are rising. The pace is yet so gradual as to be scarcely noticeable to any but the frugal, but cost of living indexes have already shown a slight increase since 1933. It is gradually costing more to live, and from all indications, the end of the rise is not yet

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imminent. Indeed, to the competent observer, there is much evidence that living costs may continue to rise—to what probable or possible heights one prefers not to conjecture.¹

Now this—the cost of living—as suggested above, does not make a great deal of difference to the bank or the life insurance company. They will be called upon to pay out deposits, mature policies and pay death claims, but these liabilities are all in dollars—whatever kind of a dollar Congress may decree. Whether that dollar will buy only ten pounds of sugar where it used to buy twenty; or whether it will take twenty of them to buy a pair of shoes or a dress, where ten used to suffice, is of little concern to the bank or the life insurance company. They have fulfilled their obligations when they pay out the dollars. Their liabilities are in *dollars*.

But the cost of sugar and shoes and dresses *is* of concern to the investor who has just about enough income to go around. His liabilities are not in dollars. They are in sugar and shoes and dresses; in gasoline and fuel and rent or taxes.

When the conventionally conservative investor begins to see what is happening to him, he can take his choice of several remedies. One of the most popular is to curse the government and attempt to reduce his scale of living. Another is to seek a higher rate of return on his investments, which, as I have mentioned before, is very likely to result in capital losses. The third, and it would seem the most expedient

¹ "Inflation" will not be discussed in these pages. Those desiring more information on that subject may address the author, requesting a free copy of the booklet *Inflation and the Investor*. See page 197.

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remedy, is to become a *truly* conservative, instead of a *conventionally* conservative, investor.

The *truly* conservative investor realizes that in addition to capital conservation, his program must achieve *purchasing power preservation*. In periods of falling interest rates and rising prices he must, if he would be *truly* conservative, seek and attain a sufficient degree of capital appreciation to offset his decreased income and his increased cost of living. *Conventionally* conservative investors, who refer to such endeavor as "speculative," talk in the language of the bank or the life insurance company, whose liabilities, as we have seen, are in dollars; or in the language of the extremely wealthy who have sufficient capital to live comfortably even though living costs should rise and their income continue to be reduced. But our problem is not the problem of the bank, nor of the life insurance company, nor of the extremely wealthy. It is the problem of the investor whose income and expenses are, or have been, somewhere near equal.

Let us see what the *truly* conservative, competent investment manager does about it. In the first place he recognizes the existence of the long trends, up and down, of interest rates, business activity and commodity prices. He understands the basic investment principles that long-term bonds and preferred stocks must not constitute too great a proportion of his fund during periods of rising interest rates, and that common stocks must not be employed in too great proportions in periods of decreasing business activity and falling commodity prices. He also has noted that periods of increasing business activity and rising commodity prices

CAPITAL CONSERVATION

afford an opportunity for reasonably safe investment in the common stocks of properly selected companies, in industries which are favorably affected by those conditions. So, in periods favorable to common stock investment, while his conventionally conservative brother invests only in bonds, preferred stocks and mortgages, he (the *truly* conservative) invests a portion of his funds in carefully selected common stocks *of the industries which are favorably affected by increasing business activity and rising commodity prices.*

The result is, that about the time the *conventionally* conservative investor is beginning to be pinched, the *truly* conservative investor, if his account has been successfully managed, finds himself with capital sufficiently increased to offset both his lower rate of income and the higher cost of living.

The *conventionally* conservative investor will perhaps rejoin that he does not want to assume even the "comparatively little risk" referred to above. This thought brings us right back to the differences between *conventional* conservatism and *true* conservatism. The investor who believes that conservatism consists solely of the "preservation of capital" must take his loss of purchasing power philosophically and be satisfied with the thought that his dollars are still there, even though they will not buy as much as they used to. There is an old story about the mortgage banker who, along with his clients, lost everything he had. "At least," he is reported to have proudly maintained, "we were ruined conservatively." Of the same class, J. M. Keynes, in his "Essays in Persuasion," says: "(he) Alas! is not one who

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foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him."

Conventional conservatism considers only the "Conservation of Capital"—of dollars. True conservatism, *in addition* to dollar safety, envisages the purchasing power of those dollars and seeks "Purchasing Power Preservation."

Very sincerely yours,

H. G. CARPENTER

Letter No. 15 . . .

CHANGE VS. SPECULATION

DEAR MR. SMITH:

I feel positive from our correspondence that you are in no way troubled with an inclination to speculate. It is more, therefore, because I want you to understand *our* position on the subject that I write this letter to you.

Conventional conservatism regards change in security holdings with suspicion. I have met many investors whose avowed policy is to buy "safe" securities and then "keep them," as one man expressed it, "until they mature, are called or default." (Upon further questioning he also admitted that he continued to keep them *after* default.) Unavoidable errors will cause losses enough so that investors of this type must reconcile themselves to an annual loss of two or three per cent of their principal, even under most favorable circumstances. Often it will be more.

Thus it is seen that *conventional* conservatism, in its attitude toward change, does not attain the end which it professes as its goal. It not only ignores purchasing power preservation, but it does not even conserve capital successfully.

Conventional conservatism attempts to select *riskless* investments and then hang on to them. *True* conservatism recognizes that there is a degree of risk in *every* investment. *Conventional* conservatism would like to deny the certainty of occasional losses. *True* conservatism recognizes their inevitability and plots its course to offset them with profits

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when it is reasonably safe to do so. *Conventional* conservatism either denies the existence of investment price trends and their repetitional characteristic, or makes no attempt to follow them. True conservatism recognizes the existence of these trends and realizes that it is possible *for the able investment manager* to anticipate them *with a fair degree of accuracy*. *Conventional* conservatism either denies the cyclical characteristics of a majority of the many industries, or makes no attempt to discern them. True conservatism realizes that the reaction of the industries to the varying economic characteristics of different periods is of far-reaching importance in the successful management of money. In short, *conventional* conservatism denies the advisability of the occasional change of investments, while *true* conservatism recognizes the necessity of change to meet changing conditions, if good results are to be secured. There is nothing surer than the certainty of change.

In contrast to the conventionally conservative investor who fears change, there is another type of person who cannot be charged with any kind of conservatism, who carries the change idea to an unwise extreme. He is or would be a "trader," a speculator. He attempts to "catch minor reactions" or expects his investment adviser to do so. He looks for "perfection" in the management of investments, which at best is an inexact science, his standard of perfection being what a speculator would do who possessed a file of, let us say, the Wall Street Journal over the *next* several years. His hindsight is perfect.

This type of investor does not fully realize the difference

CHANGE VS. SPECULATION

between investment and speculation, nor has he learned that in nine cases out of ten, if not indeed ninety-nine out of a hundred, the speculator has less money a few months or a few years hence, than the investor. He does not realize that, even though he makes an occasional fortunate "short turn," the losses which are certain to result from that type of operation are bound to exceed the profits.

Speculators always remind me of liars. One lie almost always leads to another to cover up the first one. The speculator takes unwise risks and loses part of his money. Then, like the liar, he takes more unwise risks in an effort to recover his losses. The more he loses, the longer chances he takes until he finally loses all. It is the same process as "always investing for income," only it is far more dangerous and almost certain to lead to eventual financial ruin.

I have known dozens of men of this type. One of them came to me a year or two ago telling me that he had lost over \$400,000 and had only \$100,000 left. Our firm agreed to advise him and applied to his investments methods which had been successful in avoiding serious depression losses and in increasing investment funds substantially during the period through which he had lost four-fifths of his capital. But he could not stand it. His hindsight was perfect. When he saw that a stock had risen he would complain that we "ought to have had him in on it." It did no good to prove to him that this represented short-term speculative trading and had nothing to do with investment. The stock had gone up and we should have "been in on it." He was a

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glutton for tips and "inside information" and still wanted to follow them, although admitting they had cost him \$400,000. He studied the newspaper stock reports daily, read three or four blatant financial journals which are never found on competent investment managers' desks, and wasted a great deal of time that he might better have devoted to his business. He tried to mechanize the immensely difficult problem of investment management with some "system." He admitted that 4 per cent would be a good return from a wholesale grocery business, or 5 per cent from a retail shoe store, but insisted that the most highly competitive business in the world, investment management, should yield fabulous profits. He would listen to every argument *except* the one that his investment counsel, who had achieved a reasonable degree of success in the past, could tell him how to protect his capital and its purchasing power. He remained our client for a year and then I guess was as glad to leave as I was to have him go. Since that time I understand that he has lost over half of his remaining \$100,000. It will not take him long to lose the rest. Men and women of this type are the easy prey of stock market operators, dispensers of inside information, tipster sheets, low-grade financial journals, conscienceless advisory services and the account-churning type of broker and customers' man. Such "investors" are shunned by truly conservative investment counsel organizations.

Very sincerely yours,
H. G. CARPENTER

“PREMIUM” ISSUES

DEAR MR. SMITH:

Here is one more subject of some importance on which it might be well for us to reach an agreement, thus avoiding any possibility of misunderstanding later on, in our recommendations for your fund.

I refer to the subject of “premium” issues of bonds and stocks—particularly of stocks. By “premium” issue I mean the higher-grade, better-known issues, such as those of E. I. du Pont de Nemours & Company, Eastman Kodak Company, General Motors Corporation, United States Steel Corporation, American Telephone and Telegraph Company and many others equally well and favorably known.

The securities of such companies as these, because they are so well known and so favorably regarded, usually command a “premium” in the prices of their security issues, in comparison with the issues of other less known companies.

Some investors feel a greater degree of comfort by limiting their investment to the premium issues. Others have no objection to including a few issues of the less popular companies, if it can be proved to their satisfaction that the non-premium issues have a better opportunity for several years ahead in proportion to their current price. That usually means, too, that a greater yield can be secured from the non-premium issues.

We adhere generally to the better-known issues, and

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when we do depart from them it is always in listed securities whose marketability we believe is adequate. We are, however, constantly reviewing new accounts which are coming under our direction. In making up our reviews it occasionally happens that we run across an issue, not on the list we watch regularly, which seems to be under-priced in comparison with similar issues of the better-known or "premium" companies.

Though certainly far from the conventional idea of limiting investment to the so-called "blue-chip" issues, we believe it is the part of wisdom, when such an issue is found, to recommend relatively small holdings of it to those of our clients in whose portfolios it would be suitable. It does not always follow that, because the securities of a certain company or industry are popular at a given time, they are necessarily good investments. I remember the high regard in which the securities of the New York, New Haven & Hartford Railroad were held in the first decade of the century and the high investment rating given those of the Chicago, Milwaukee & St. Paul Railroad Company at the same time and a little later. In the second decade of the current century American Sugar Refining was regarded as representing a very sound investment value, yet its subsequent record has been one of persistent decline. I remember also the high opinion that conservative investors had for American Woolen common in the early 1920's and how fortunate some considered themselves to purchase the stock at around the low point of about 60 in 1921. Yet as little as

"PREMIUM" ISSUES

three or four years later the position of the company had deteriorated seriously.

In 1925 stocks of railway equipment companies, particularly American Locomotive Company, commanded a high investment rating because of the strong financial position of the companies and the earnings they had enjoyed during the preceding several years, yet they have been on the down-grade practically ever since. During the first two decades of the century, and to some extent in the third, railroad securities were, par excellence, the outstanding conservative investment. I can remember when it was considered hardly respectable to hold anything else. An examination of representative investment lists will indicate that even in 1929 railroad securities were still very popular with conservative investors. Yet of course they suffered extremely severe declines in the years following.

The tale of the utilities in the 1920's and 1930's is a similar one. "Not a cloud in the sky." It is easy to remember people who thought of Consolidated Gas as something one could buy at almost any price and put away and forget.

It would be easy to multiply these examples. Anyone whose financial experience goes back more than a few years can think of numerous similar instances. I am sure that you can without my referring to any more.

It is too bad, of course, that this theory of adhering to the better-known, more popular issues does not provide an entirely satisfactory investment method. It would be delightful if it did, because it is so extremely simple. If it were sound all the elaborate research work, careful balancing of

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favorable and unfavorable factors, study of economic conditions, and so on would be unnecessary.

What the theory comes down to is the buying of securities at the time that they are the most popular and consequently are selling at the highest prices. If a satisfactory result is to be achieved in investment it is surely not by such means but rather by something fairly near the opposite.

The above of course does not mean that we do not use the stocks of well-known companies. It *does* mean, however, that we must give careful attention to fundamental values and must attempt to obtain these values at favorable prices. I believe that we are far more likely to get better results if we look for fundamental values which are temporarily selling at a discount, because a particular security or industry is *not* popular, and that in the end a good investment result depends upon ability to recognize such fundamental values, and upon having the courage to purchase them, in spite of the fact that they may be *un*popular at the moment. Independence of mind is certainly essential, for it is impossible to buy at anything like bargain prices if one looks for the things that are most popular.

My purpose in addressing this letter to you is to inquire how you feel on the subject. Will you please let me know at your convenience?

Sincerely yours,
H. G. CARPENTER

Letter No. 17 . . .

OTHER COSTLY INVESTOR ERRORS

DEAR MR. SMITH:

When a naval engagement is imminent, I am told by one of my Navy friends, a ship is stripped for action by dispensing with boats, canopy frames, stanchions, the clothing of officers and men and other inflammable gear. At a later stage, before the battle, the engines are prepared for full power, the fire hose is connected and the weather decks wet down, prisoners are released, war heads are put on the torpedoes and finally the ammunition brought up to the guns. The deck is then "cleared for action"—and the battle ensigns hoisted at the masts.

In the management of investments, it is also essential that "the deck be cleared for action," the "deck" in this instance, however, being the mind of the investor. In the preceding letters I have discussed several points which have come to my mind as I sat down to dictate letters to you. In addition to those there are several common and costly investment errors which sometimes escape one. I am not going to dwell upon these errors to any great extent because I feel sure that you are as fully aware of their dangers as I am. However, let me mention them briefly so that there will be no possible chance of their escaping our attention.

The three mistakes I am going to mention, strange to say, have to do with first principles, the ABC of successful investing. Everyone recognizes them as principles. Every book

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on investment names them. Anyone will admit, upon questioning, that they are essential to investment success. And yet many an investment program which might otherwise be fairly successful is doomed to mediocrity at the start because of failure to observe these basic principles.

MARKETABILITY

The first of these errors which I want to touch upon is the disregard of marketability in the selection of investments. "Marketability" not only generally implies listing on the New York Stock Exchange for American securities but it also calls for *activity* on the Exchange. A listed security which is bought and sold only occasionally on the Exchange has little better marketability than one with an "over-the-counter" market. Indeed, some (a very few) *unlisted* bonds, because of a great deal of activity, have a better market than many listed bonds. You can almost always sell securities with poor marketability when you don't want to, but when you need to, and need to badly, you will either have to sacrifice so much that you won't sell, or you will not be able to find any market at all.

Just one example and then I will go on to the next common and costly error. Our old minister, Rev. Baird, congratulated himself in 1930 that he had always stuck to safe investments with the few thousand dollars he had accumulated. These "safe" investments were "Guaranteed Real Estate First Mortgage Gold Bonds." Dr. Baird decided, however, that things were not looking any too well and that he would sell his bonds in preparation for a round-the-world

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cruise he and his wife had long anticipated. To his great surprise he was quoted prices of 75, 60, 50 and as low as 40 (\$400 for a \$1000 bond), while listed, readily marketable issues were quoted close to par. These prices were "ridiculous" and Dr. Baird held on. Soon the defaults began, and shortly he found himself with no income and little principal left. He had paid heavily for neglecting marketability. There was no round-the-world cruise for Dr. and Mrs. Baird.

The investor who neglects marketability is usually one who does not appreciate the necessity of change, or who sacrifices marketability for 1 or 2 per cent additional income. One should never forget that economic conditions change, that the outlook for whole industries changes and that the fortunes of individual companies can deteriorate rapidly. Marketability is never a good trade for yield. A mere 1 or 2 per cent temporary additional income, if purchased at the price of marketability is almost sure, eventually, to cost many times the temporary apparent benefit which may be derived.

DIVERSIFICATION

One would think that the defensive rule of diversification would be so universally recognized and accepted that no word of caution could possibly be needed. And yet, time and again, one finds serious losses developing from the neglect of this first principle. Violation of this primary rule usually results from over-optimism regarding the prospects of some company—optimism perhaps inspired by "inside

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information." On the other hand, neglect of the diversification rule is frequently induced by a desire to be ultra-conservative. Two examples will serve to illustrate my points.

An able investor with whom I have discussed this subject has a general investment rule that he will not invest over one-twentieth of his capital in any one security. However, in years gone by he has on numerous occasions departed from this rule, when he felt that he was particularly sure of himself. So frequently, he tells me, has it happened that his "sure" securities turn out to be less satisfactory than his others, that now, whenever he oversteps his customary limit, he lays a wager with his wife *that he has made a poor selection!*

It may have sounded strange to you when I said, a few lines above, that a desire to be ultra-conservative sometimes induces neglect of diversification—often with bad results. It happens, nevertheless. One of my friends recently came to me with his list of securities totaling approximately \$100,000 at current prices. He seemed to have employed a reasonable degree of diversification with one exception. He had \$40,000 par value (\$25,000 current value) of a defaulted Guaranteed Mortgage bond issue. I suggested that 25 per cent of his entire fund was too much for one security.

"It used to be *more* than that," he replied. "I bought those bonds at par. Paid \$40,000 for them."

"But why," I asked, "did you place so great a percentage of your fund in one issue?"

"Safety," he answered, disgustedly. "Safety. They sounded

OTHER COSTLY INVESTOR ERRORS

so safe and were recommended so highly by the institution which sold them to me that I placed what was at that time 50 per cent of my capital in them." Over-caution had induced that man to violate the simple, old-fashioned rule of diversification.

There are many other rules, canons, guides, standards, precedents, maxims, etc., regarding investment, but diversification is a primary law, the principal principle. The rule of adequate diversification should never be transgressed. Investment is not an exact science. We are always dealing with probabilities, never with certainties.

TAKING LOSSES

An investment counsel once told me a story about two of his clients which nicely illustrates the reluctance of some investors to "take" losses.

It seems that the investment counsel organization had sent out recommendations to a number of its clients for certain changes in their accounts. Among others were two men whom I shall call Mr. Black and Mr. Brown. Black and Brown, each happening to be in the vicinity of the counsel's office a day or two after the recommendations had been made, decided to drop in and talk things over with their investment adviser. They chanced to meet in the same elevator and, being close friends and each knowing that the other was a client of the office, they went in together.

After a few minutes' friendly chat Mr. Black said to the investment counsel: "I received your recommendation yesterday and I think you people are exactly right. I have a

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nice profit in those bonds and I sold them right away, just as you advised."

Mr. Brown then broke in with: "I wish I could say the same for the advice *I* received from your firm a day or two ago. I don't agree with you at all. I paid par back in 1929 for the issue you want me to sell. I saw the bonds go down to forty during the 1929-1932 depression and was certainly pleased that you advised holding them when I retained you as my investment counsel. Now that they are back to ninety I don't see any reason for selling. I'd like to hold on until I can break even anyway. If I sell now I'll have to take a loss of \$500."

"Well, that is unfortunate, Mr. Brown," replied the investment counsel, and turning to his other client, he said: "Mr. Black, what do you think? Does it strike you that Mr. Brown's objection is a logical one—that he ought to hold his bonds for 100?"

"It sounds reasonable to me," replied Black. "I'm sure I should feel just as Mr. Brown does under similar circumstances."

That was exactly what the investment counsel wanted. "Let me tell you two something," he said. "You are both talking about the *same* issue! Mr. Black approves of our recommendation because he has a profit. Mr. Brown disapproves because he has a loss. Furthermore, you, Mr. Black, have just said that you would reverse your opinion if you had a loss in the issue instead of a profit. Now, let us use a little common sense about this matter. We are recommending the sale of the issue, in spite of its recent price

OTHER COSTLY INVESTOR ERRORS

advance, because the earnings of the industry to which that company belongs have not been increasing as satisfactorily as those of certain other industries. We believe that the price has advanced too far in comparison with other similar issues, that there is considerable likelihood of a decline, and that there is at least a possibility of eventual default the way things are going. We believe there are several other issues of the same coupon, selling at about the same price, which offer a better opportunity for appreciation over the next few years, at less risk.

“But you gentlemen apparently do not want to base your action on conditions within the industry, nor within the company. You evidently believe that *your* personal profit or loss in this security, in some miraculous way, is going to affect its safety and its price trend. Conditions within the industry may be bad. The industry, or the company itself, may be deteriorating because of poor management, bad labor policies, obsolescence of equipment, new inventions, government competition or any one or more of a dozen other possible reasons. But all of these things are as nothing in comparison with the circumstance that one man, among thousands of bondholders, happens to have a loss. And furthermore ——”

But here Mr. Brown interrupted. “That’s enough,” he said. “I see the idea now, and I only wish someone had pointed it out to me twenty years ago as clearly as you have just done. It would have saved me many thousands of dollars. I’ll sell those bonds as soon as I get back to my office.” Mr. Black agreed and the conference ended.

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I am sure that nothing further would be needed to convince anyone that his position in a security, his profit or loss, his reluctance to "take" a loss, can possibly have the slightest influence on that security's true value or on its price trend.

Very sincerely yours,
H. G. CARPENTER

Series IV

**BRIEF OUTLINE OF THE TREATMENT OF
SEVERAL CLASSES OF INVESTMENT
ACCOUNTS BY A COMPETENT
INVESTMENT COUNSEL**

Letter No. 18 . . .

RETAINING INVESTMENT COUNSEL

DEAR MR. SMITH:

This will acknowledge your letter of the fourteenth, and I am very appreciative of your kindly comments on my discussion of the fundamentals of investment management, on the choice of investment advisers and on the pitfalls to be avoided.

I am appreciative, too, of your interest in the material I have sent you regarding the methods, facilities, organization and results of this office, and am of course particularly pleased at your request for information regarding our fees and the steps to be taken to place an investment account under our counsel.

Our fee depends upon the size of the fund and the type of counsel you desire to have us apply to your account. For the most difficult type of management, the "major economic trend" method, our charge is of course the highest.

For the "median line" method, which, being more or less mechanical, requires less work and attention on our part, the fee is slightly less.

We also offer a third type of service which we call our "quarterly commentary" method. In this service we pay no attention to economic trends, and the account receives no attention from us between the "quarterly commentaries," which are limited to suggested changes with brief reasons for such changes. This method cannot properly be termed

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"investment counsel" because so large a part of our regular counsel is left out. The "quarterly commentary" method is designed primarily for funds which are restricted to "legal" investments, that is, securities "legal" for trust fund investment." It is employed largely by trustees of estates or institutions. This service is also occasionally employed by those who are cotrustees with trust companies, and who must therefore approve the management of a trust fund by the corporate trustee. The "quarterly commentary" service equips the cotrustee with information and statistics which enable him both to make recommendations to the corporate trustee and to pass intelligently upon the corporate trustee's actions.

The second, third and fourth quarter fees each year (if fees are paid quarterly) are based upon the value of the fund *at the beginning of the counsel year*. Discounts of 3 per cent and 6 per cent, respectively, are allowed if fees are paid semiannually or annually in advance.

As to the steps to be taken to place an investment fund under our counsel, the procedure is very simple. All you do is to send us a list of your investments, stating which type of counsel you want us to apply to your fund. The list should be limited to marketable stocks and bonds. (We do not have the facilities to counsel you regarding mortgages, real estate or other types of investments.) If you own any securities which you feel that you *must*, for any reason, continue to hold, they should be marked accordingly. We will not charge you for such securities, but will keep a memorandum of them so as to avoid concentration of too

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great a percentage of your fund in related industries or companies.

Upon receipt of your list, we will mark the current price after each item, total the items, send you a copy of the list with a statement of the fee and a question form designed to acquaint us with your circumstances, objectives and preferences. Immediately upon the return of the latter to this office we begin work on our initial review of your account which usually requires between two and three weeks. We will also write you a letter outlining our understanding of the methods to be employed in the counseling of your account and any other details on which there might be any chance of misunderstanding.

We believe that we can be helpful to you. The best way to prove it is to show you, so we make it just as easy as we can for you to try us. If you are not satisfied, we want it to be just as easy for you to stop.

I believe the above will give you all of the information you require but if you have any more questions, please write me again. On the other hand, if everything is clear to you, and you want to try us as your investment counsel, please send us your list of securities. This should also include a statement of the amount of cash now available for investment. You understand, of course, that all information regarding your affairs will be considered as absolutely confidential.

There is one more thought I want to suggest to you in this letter, a thought which springs from the experience of all investment counsel organizations.

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When security values are *advancing* smartly, new accounts come in readily—accounts of investors who have appreciation chiefly in mind. And when security values are *declining*, new accounts also come in readily—accounts of investors who are fearful of serious losses. But in those periods of doldrums, *between* advancing values and declining values, or vice versa—when nothing particularly exciting or alarming is happening—there is usually a dearth of new accounts.

As it happens, those doldrum periods are the best periods in which to place an account under the direction of competent investment counsel, for the following reasons:

1. In the first place, the investor is not hurried in his decision, either because of a desire for quick profits, or because of fear.
2. Secondly, the investment counsel organization is not likely to be extremely busy, and can therefore take its time in preparing its analysis and review of the new account—a far different and more favorable status than being hurried by a worried client.
3. In the third place, something “exciting” or “alarming” *can* happen, and *will* happen, sooner or later—perhaps sooner than one expects. The preparation of an investment account for such happenings is not made the day or the week before the occurrence of the event.
4. Lastly, the mutual understanding and confidence essential to the most satisfactory counsel-client relation-

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ship are not established instantly. It is far better to get settled and become acquainted with each other in a period of relative calm. Then, when the period of stress comes, both client and counsel, as well as the client's account, will be in better position to meet it.

Looking forward to hearing from you at your first convenience, I beg to remain,

Very sincerely yours,
H. G. CARPENTER

Letter No. 19 . . .

THE FUND OF A SUCCESSFUL, AGGRESSIVE BUSINESSMAN

DEAR MR. SMITH:

Our initial "analysis and review" of your investment fund has now been completed and is going forward to you. I hope the 150 pages required will not tax your patience to too great an extent. This task of rearranging a \$300,000 fund, comprised of fifty-six different issues, is not a simple one, particularly as it is our practice to give our clients concrete reasons for every change we recommend.

You will note that the "analysis and review" is divided into seven parts, as follows:

- I. Survey of the Principles of Investment
- II. The Present General Economic Situation
- III. The Effect of Changes in General Business Activity and Commodity Prices on the Earnings of Different Types of Companies
- IV. Your Present List
- V. Our Recommendations
- VI. The Effect of Our Recommended Changes Upon the Position of Your Fund
- VII. Conclusion

In *Part I*, "Survey of the Principles of Investment," we have given you a brief outline of the principles of investment as we conceive them. While you are, I believe, already

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well aware of the principles to which we subscribe, this section of the analysis and review of your account is a sort of formal notice of the methods we intend to employ in making recommendations for your fund.

In *Part II*, "The Present General Economic Situation," we set forth our conception of the current conditions. Our original recommendations for your account are of course based on current conditions as we see them.

In *Part III* we explain how earnings of the different types of companies are affected by changes in the major economic trend or by changes in the prices of commodities. A careful study of this section of the analysis and review will serve as an excellent foundation for your thorough understanding and appreciation of the changes recommended for your fund.

In *Part IV*, "Your Present List," we comment at considerable length upon each and every security comprising your present list, giving concrete reasons why it should either be held or sold. In this section we have prepared tables which develop the following information regarding your present holdings:

- i. Percentage devoted to:
 - A. Short-term, high-grade bonds
 - B. Long-term, high-grade bonds
 - C. High-grade preferred stocks
 - D. Earnings-dependent securities
 - a. Second-grade bonds
 - b. Second-grade preferred stocks
 - c. Common stocks

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2. Percentage of earnings-dependent securities devoted to:
 - A. Issues which fluctuate widely
 - B. Issues which fluctuate moderately
 - C. Issues which fluctuate narrowly
3. Percentage of earnings-dependent securities devoted to:
 - A. Issues whose fluctuation normally conforms very closely to the general business cycle
 - B. Fairly closely
 - C. Only moderately
 - D. Remotely
4. Percentage of earnings-dependent securities devoted to:
 - A. Issues which are affected to an unusual degree by changes in commodity prices
 - B. Those which are moderately affected
 - C. Those which are only slightly affected, if at all.

It is surprising how this four-way approach will frequently develop serious inconsistencies in an investment account, which might easily pass unnoticed when the fund is viewed in the ordinary manner.

In *Part V*, "Our Recommendations," we discuss at length each substitute security that we are recommending for purchase.

In *Part VI*, we show the effect of our recommendations upon the position of your fund—how the changes we have

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advised provide a balance in the several tables discussed above—a balance, we believe, better suited to current economic conditions than was your account when it came to us.

Our analysis and review, as you will note, first takes the house, which is your fund, apart. We examine each stone and timber carefully, eliminating those which seem unfit for service in the current economic weather. Then we rebuild the house, substituting materials which in our opinion are better suited to the present economic season.

You will note that we have increased the percentage of earnings-dependent securities in your list and that we have included more of those (1) which are subject to wider fluctuations, (2) which follow the general business cycle more closely and (3) which are affected to an unusual degree by changes in commodity prices. While we have not recommended a high percentage of earnings-dependent securities *at this time*, we believe that your circumstances, your age, and your income from sources other than investment, all warrant a *maximum* investment in this type of security, *under most favorable circumstances*, of approximately 80 per cent of your fund.

I hope you will not only read, but study the analysis and review very carefully. You will find it well worth the time required. May I suggest, too, that as you study it you make notes in the margin opposite any part which you do not understand. Then write to us about each part which is not entirely clear to you.

It is only by clearing up misunderstandings as we go

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along that we will be able to firmly establish that most satisfactory of all financial relationships—the cordial alliance of a frank, reasonable, well-informed investor with a competent, sincere investment adviser whose entire source of revenue is such that his interests coincide exactly with those of his client.

We shall hope for a letter from you in the near future.

Very sincerely yours,

H. G. CARPENTER

Letter No. 20 . . .

INCOME TAXES AND INVESTMENT MANAGEMENT

DEAR MR. SMITH:

We are in receipt of your letter of the twenty-first and are so pleased to hear of your "complete approval" of our analysis and review of your investment fund.

It is a little disturbing to us, though, to have you say that you will not execute a number of our recommendations at this time because you can save "a great deal" in income taxes if you delay the sale of certain securities for several months.

Since income taxes have become so high there is a great deal of talk (and a great deal of misunderstanding) about managing investments so that they may be avoided, or at least materially reduced. There is not much foundation for any such belief. It is too bad that income taxes are so high, but they are, and they have to be paid. There is little that can be done in the management of investments to reduce them—this in spite of extravagant claims by some "tax experts" who profess ability to save a sizable portion of them by some sort of investment management wizardry.

I don't know just how carefully you have figured the amount you are going to save, but on the bare chance that it may be helpful to you, let me cite you one or two examples of income tax saving (?).

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EXAMPLE I

Mr. W was advised by his investment counsel (*not* the tax wizard kind) to sell a certain common stock in January, but he waited until April because by April he would have held that particular stock five years, and that would "save him 20 per cent." (This was several years ago, before the 1939 revision of the capital gains tax.) "Twenty per cent of what?" the counsel inquired. This puzzled Mr. W for a moment but with some help he finally stated that it would enable him to deduct 80 per cent *of the tax* on his *profit* instead of 60 per cent, thus saving 20 per cent—not of the *price* of the security, nor of the *profit*—but 20 per cent *of the tax*. It then developed that Mr. W's top tax bracket was 18 per cent. Thus he would save 20 per cent of 18 per cent—or 3.6 per cent *of his profit*. (His *profit*, if the stock had been sold as recommended, as it happened, would have been 33 $\frac{1}{3}$ per cent of the sale price.) Three and six-tenths per cent of 33 $\frac{1}{3}$ per cent is 1.2 per cent *of the price of the stock* when he was advised to sell. Mr. W postponed the sale of his stock for three months to save 1.2 per cent of its value in taxes! During that three months' period, the stock declined 12 per cent—just ten times the amount of the "saving." Mr. W later admitted that he "never had figured it out"; that he "just had a hazy idea the tax 'saving' would amount to about 20 per cent of the price of the stock." (If the profit had been of sufficient size, it would, of course, have changed Mr. W's bracket to a higher one.)

INCOME TAXES

EXAMPLE 2

Some investors employ tax exempt securities to save on their income tax. Many of these, I fear, have not stopped to realize that the price of good tax exempt issues is made by the demand for such securities from *very* wealthy investors. An investor, for instance, who pays an income tax of 50 per cent can well afford to invest in a tax exempt security yielding 2 per cent rather than a taxable issue which yields $3\frac{1}{2}$ per cent or 4 per cent. But the investor who pays only a 10 per cent or a 20 per cent income tax cannot afford any such reduction of income. He is paying for something which he cannot use profitably.

We hear each December about "establishing tax *losses*." There is something to this *if* one is careful not to let his *investment* judgment be warped by his desire to save on his income tax. Our rule is to ask our clients each year whether they need to establish an excess of profits *or* losses, and then we see what we can do for them without recommending something that would be to their investment disadvantage. It seems to me that this is about as far as investment management should be combined with tax saving.

Back in 1929 there were many people who thought securities were too high, but they would not sell their holdings because they would have to pay an income tax on the profits. What happened to these people is an excellent example of mixing income tax saving and investment management. The head of our office says, with a note of sarcasm, that he has seen frequent instances of investment funds being

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managed primarily with the idea of avoiding income taxes. "In all the cases that I recall," he says, "the effort has been completely successful, although for a different reason than was intended. So much attention was paid to avoiding taxes that the result was that there were no profits to tax—but usually plenty of losses, which, however, were of no use as there were no profits to offset against them."

So much for "Income Taxes and Investment Management." All of the above does not mean that it is not important to have sound advice on taxes—more particularly on estate and inheritance taxes. The point is that the income tax problem is *a separate problem from that of investment management*, and that, compared with investment management, the income tax problem is a rather simple one.

May I suggest that you recalculate the saving referred to in your letter. You *may* find that it won't pay to combine too much tax saving with your investment management.

Very sincerely yours,

H. G. CARPENTER

Letter No. 21 . . .

MRS. SMITH ASKS THREE PERTINENT QUESTIONS

MY DEAR MRS. SMITH:

This will acknowledge receipt of your letter of the eighteenth from which I note that the experience of your husband with our organization has led you to believe that you "might" want to retain us as counsel for your investment account. Your three questions are all pertinent. Let us consider them one at a time.

First you say that Mr. Smith is very much pleased with our work on *his* account, but that you are in an entirely different position than he. You point out very properly:

1. That Mr. Smith has a large income from his business while you have none except that from your investments;
2. That your money was left to you by your father as a protection to you in the event of need, and that you want to keep it as a sort of backlog in the event of misfortune to Mr. Smith's business, which you suggest might, in the event of a serious depression, exhaust *his* investment account;
3. That Mr. Smith is an aggressive personality who is not entirely happy unless he is assuming some risk, while you are exactly the opposite;

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4. That your tax problems are entirely different from Mr. Smith's;
5. In view of all of these differences, you say that you wonder whether our policies would be suitable for your account.

Mrs. Smith, you have put your finger right on one of the most distinctive features of investment counsel. When an investment advisory organization is also engaged in some other business from which it derives a part or all of its income, it can very easily become lopsided—leaning toward one type of security or one line of procedure. An investment counsel, on the other hand, with no interest to serve except the client's welfare, if he knows his business, can direct a conservative investment program just as well as an aggressive one. We have not set up an investment management policy which all of our clients must follow. *We adapt our policies to the circumstances and objectives of each client.* We are like a capable chauffeur who hurries father to the office at eight o'clock, transports mother to and from her shopping at ten, and takes grandma leisurely through the park in the afternoon. One does not select a chauffeur because he is a *fast* driver, or a *slow* driver, but because he is a *good* driver—a *careful* driver *under all circumstances*. Likewise, one should select an investment adviser because he is competent. If he *is* competent, he will be just as successful in directing an investment program for you, as for your husband, even though the difference in your circumstances, objectives and preferences may require the employment of different investment policies.

MRS. SMITH ASKS THREE QUESTIONS

Your second question relates to the fee. You point out that our fee for counseling your \$200,000 investment account would be one-sixth of the maximum income you could hope for at this time. If I concurred entirely with your reasoning that the fee to be paid "out of your income" is the "most important consideration," I would suggest that you have us employ either the "median line" method or the "quarterly commentary" method in the counseling of your fund. But I cannot say that I do concur with your reasoning. While income is undoubtedly of some importance to you, it certainly is not of major importance. Your *first* objective, it would seem, should be the conservation of your capital; your second, the preservation of its purchasing power. If your husband's business collapses and takes his investment backlog with it, you want to be able to step into the breach with capital of sufficient proportions to live on the income; not only at the present cost of living, but at a higher cost of living, if living costs should advance in the meantime.

You must not confuse your objectives, Mrs. Smith, nor should you forget that the investing-for-income method employed in the management of your fund during the last seven years has not been very satisfactory in comparison with the results achieved by this office. In fact, it would appear that you could have paid a much larger fee and still be far ahead of your present position.

There is one more suggestion which I should like to make at this point. It seems to me that investment counsel fees should never even be thought of as a percentage of income. The *competent* investment adviser will spend 90 per cent of his effort in conserving capital in bad times, and in

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preserving purchasing power in periods favorable to investment. Why, then, should his fee be considered as a percentage of income or a charge against income? I don't believe it should. It seems to me that it is properly a charge against *capital*. It may happen to be 10 per cent of income at one time and 25 or even 50 per cent at another. The better the management is, the larger is likely to be the ratio of the fee to income during depression periods, when competent counsel is most needed. For one to think of the fee in relation to income distorts the question in a way which is often disconcerting and sometimes deceiving.

You may select the "median line" method or the "quarterly commentary" method if you still believe it advisable, but it does not seem to me that either of those methods is well adapted to the objectives of your fund.

Your *third* question had to do with "long-distance counseling" as you phrase it, and I note your fear that you might not be as well satisfied with a counselor in New York as you would be with one in your home town where you could consult with him frequently.

If you can find an equally competent adviser in your city, it might perhaps be a source of satisfaction to you to have him near at hand, but beyond that it would make no difference. Successful investment management, after all, is not so much a matter of talking it over as it is of knowing what to do and when to do it. Modern means of communication make you as close to us as a New Yorker, but it is seldom necessary to employ either telegraph or telephone. The investment counsel organization with which I am associated

MRS. SMITH ASKS THREE QUESTIONS

has offices in Philadelphia, Chicago, Los Angeles, San Francisco, Detroit and Boston, and we have clients in many States very far from New York, and in foreign countries. All of the management and counseling is done from New York, but we have never encountered any difficulty in serving our out-of-town clients. Many of them call on us when they are in New York—some of them, indeed, more often than many of our New York clients. There are many more whom we have never seen and who have never seen us. It all simmers down, I assure you, to ability, which in turn is most often found in conjunction with: (1) an absence of conflicting interests, (2) the “long economic trend” method, (3) adequate facilities and (4) a satisfactory composite record of results. Whether the counsel organization is near by or far away makes no difference in the quality of its advice.

I believe the above will answer your three questions satisfactorily, and if you decide to retain us as your investment counsel, I shall hope to hear from you soon with your list of investments and your instructions as to which method of management you would like to have us employ in the counseling of your account.

Very sincerely yours,
H. G. CARPENTER

Letter No. 22 . . .

"POLICIES" VS. "METHODS" AS APPLIED TO MRS. SMITH'S FUND

MY DEAR MRS. SMITH:

It was nice indeed to receive your letter of the twenty-seventh and to learn that you had so generously revised your former conclusions and that you had decided to allow us to go ahead with your account, employing the "long economic trend" method.

Perhaps I did not make clear enough a distinction between "methods" and "policies" in my earlier letters.

The term "methods," as I have used it, refers to type or kind of management employed by an investment manager or counsel. Examples: (1) the "long economic trend" method, (2) the "median line" method, (3) the "quarterly commentary" method, (4) the "invest-for-a-high-income" method, etc.

"Policies," on the other hand, might be said to refer to the extent or degree to which a given *method* is applied. Thus, in using the "invest-for-a-high-income" method, the *policy* in one instance might be to seek 5 per cent, while in another it might be to try for 6 per cent. With the "long economic trend" method one difference in *policy* might be that with Mr. Smith's account we would, under most favorable conditions, recommend the investment of as much as 75 or 80 per cent in earnings-

“POLICIES” vs. “METHODS”

dependent securities. For your account, however, with a different set of circumstances, objectives and preferences, the maximum ever recommended for earnings-dependent securities would probably be 30 or 40 per cent. Thus, while employing the same general *methods*, the difference in *policy* would adequately reflect the difference between his and your circumstances, objectives and preferences.

When you receive our analysis and review of your account I am sure you will see how adequately it reflects *your* circumstances, *your* objectives and *your* preferences.

Here I should like to say just a few words on the subject of an investor's "preferences." Yours were very definitely in line with your circumstances and objectives, except possibly for a slight misconception regarding the advisability of seeking too high a rate of income. Unfortunately, the preferences of many investors do not harmonize so well with their circumstances.

Frequently, for instance, an investor of moderate means will be over anxious to increase his capital to a point where he can live on the income. He will state his objective as "increase of capital" and forget entirely that one cannot increase his capital unless he first conserves it. A common mistake is to set a figure one wants to reach, after reaching which he promises himself he will become "conservative." Such an investor seldom reaches his objective, because investment markets, and the economic conditions which create them, pay little attention to investors' objectives.

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A competent investment counsel follows the preferences of his client only as long as those preferences are in line with the client's circumstances and objectives. When they are not, it becomes the investment counsel's duty to convince the client of the error of his thinking. This is one way, quite apart from usual investment problems, in which an investment counsel organization can be of inestimable help to its clients.

Our management department tells me that the analysis and review of your fund probably will be forwarded to you in about ten days. After you have had time to study it, we shall hope to hear from you with any comments or questions which may come to your mind.

Very sincerely yours,
H. G. CARPENTER

Letter No. 23 . . .

"HINDSIGHT"

MY DEAR MRS. SMITH:

You have evidenced no tendency to employ your "hindsight" in judging the work of your investment counsel, but it is so easy to fall into the habit that I want to talk to you a little about it.

There is a perfectly natural tendency for all of us to look back *after* the happening of a given event (such as the recent sharp decline in the prices of common stocks) and perhaps recall that we had a strong inclination to buy or sell at just about the right time. For many years I suffered from "hindsight trouble" myself, but finally developed a plan which gave me a great deal of relief. You may perhaps be interested in the story of my cure.

The investor afflicted with hindsight trouble, as suggested above, recalls *after* a rise or fall in security prices that he had a "very distinct feeling" prior to the said rise or fall that he ought to have bought or sold, as the case may have been. But what the hindsighter fails to remember is all of the *other* very distinct inclinations he may have had to buy or sell, when the outcome would not have been nearly so favorable to his investment account. The hindsighter frequently overlooks the fact that investment management is not an exact science—that it is absolutely impossible to foresee many minor (and some major) movements, either of markets as a whole or of individual securities. He forgets, too, that the

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trader, who is trying to dodge in and out of securities, almost always has less capital after a few years than the *investor*, who contents himself with the plan of attempting merely to foresee the more important changes with a fair degree of accuracy.

An adequate test of investment management methods, your own or your investment adviser's, can never be made over a period of a few months, if indeed it can over a term of several years. An entire investment cycle—from the beginning of one period of depression to the beginning of the next, or from any given point in the cycle to a similar point in the next—is the minimum time required to test the ability, defensive and offensive, of the investment manager. Again and again, however, I have seen investors whose own methods have lost sizable percentages of their capital during depressions, or who have failed by their own endeavor to achieve a substantial appreciation during periods of prosperity—again and again have I seen these investors employ their hindsight in judging the results of their adviser's management. They point out that much better results could have been secured if stocks had been sold in March—"as I had an inclination to do at the time"—and repurchased in May or June. This type of investor relies on his *hindsight* instead of learning from his *experience*. He attempts exactness in an inexact science. He still visualizes that which is both dangerous and impossible of achievement.

Hindsight trouble is not restricted to those who have the trading or speculative instinct. It often appears among other investors who too easily forget the shortcomings of their

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own methods as proved by their past experience, in comparison with the record of other more successful investment managers. A man who had lost two-thirds of his fortune by following tips of those supposed to have inside information bemoaned the loss occasioned by his investment counsel's refusal to follow one tip which happened to turn out well. Another man, half of whose capital had been dissipated by investing for income, pointed back to the additional 1 per cent which might have been secured over a short period. Still another, who had lost several hundred thousand dollars by concentrating his investments in one company, was critical of his investment counsel when the stock of that company showed a temporary advantage in appreciation over the properly diversified program the counsel had advised. Another objected to "taking the losses" which were necessitated to get his account in proper form to protect it against further loss, and then said "I told you so" when some of the securities that had been sold, temporarily advanced more or declined less than those which had been substituted. These investors probably would not bid in bridge on less than two and one-half honor tricks, even though, by hindsight, it could be shown that such a bid *occasionally* would have been successful. They would not cross a street against a red light although that, too, can frequently be done with impunity. They forget that there are some underlying, fundamental rules of investment which must never be violated, even though hindsight may show that their transgression would have been successful in certain instances.

But let me get to the hindsight cure which has been

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so helpful to me and to others who have tried it. Here is the plan. Instead of trusting to hindsight to recall those "very distinct inclinations" to make changes in one's investment account, let the hindsighter assume, whenever his inclinations are sufficiently strong, that he has actually made the changes. Let him keep a separate record in black and white, showing all changes in his account that he would have made, with the hypothetical prices he paid or received. He will then be testing his foresight instead of employing his hindsight—a far more accurate gauge of the effectiveness of those "very distinct inclinations." By this means the hindsighter can give expression to his every inclination to trade in and out of the stock and bond markets. He can try his hand at seeking a high income; he can follow all the inside information that he wants to; he can plunge in the securities of a single industry or company; in short, he can violate every principle of sound investment management that he wants to, and test the efficacy of his methods in comparison with those of his investment counsel. Usually it will not be long before he becomes convinced that, imperfect as they are, the competent investment counsel's methods, while not so exciting or spectacular, do have the advantage of a better net result over any reasonable period of time.

When you retain an investment adviser, do so only because of satisfactory evidence that his facilities, methods and record are better than yours. If his results *have been* better than yours, the reason undoubtedly lies in his more adequate facilities, his better training, his greater experience, and probably, too, in a temperament more suited to successful

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investment management. In other words, his methods are better than yours—better for the longer term, throughout one or more complete investment cycles. Having retained him because of superior facilities, methods and results, co-operate with him by following his recommendations as closely and as expeditiously as possible. Remember that he is still employing those same methods which have proved superior to yours. Remember that he cannot be perfect. And, particularly, I urge you to realize that the reason he does not follow a trading policy, or invest for heavy income, or heed inside information, or do any of the dozen and one other things that some investors do, is that his experience has taught him that such practices *will cost you money* in the long run, either in losses incurred or profits forgone.

I urge you to bear in mind constantly that investment management is not an exact science, and that any procedure based on that assumption will be costly. If you are going to use any earnings-dependent securities in your investment account (and I don't see how a conservative manager, under present conditions, dares dispense with *some* measure of their purchasing power preserving qualities) then you must reconcile yourself to fluctuations in the value of your account. A *good* manager or counsel will pay no attention at all to *minor* fluctuations. He will endeavor to foresee those of major caliber, and to reduce or increase the earnings-dependent portion of your list accordingly. He will not be perfect, even with the *major* rises and declines, and when he is not as good as he should have been, he will, if he is wise, admit his shortcomings. If he can be *reasonably* correct in foreseeing a

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majority of the major trends, however, he will conserve your capital and preserve your purchasing power—the two important objectives of investment management.

You may well reply that *too* much patience with an investment adviser may leave you seriously crippled in capital or purchasing power *before you find out that he is incompetent*. That, of course, is the danger in depending upon *your own* experience to test the ability of an adviser. It takes too long a time to find out. That is why I have laid so much stress on the importance of ascertaining the composite record of results achieved for all clients of a prospective adviser, *before you retain him*.

Select your adviser carefully, follow him closely, and if you are ever tempted to use your hindsight in judging results, I most particularly urge you to employ, instead, the plan suggested above. Compare your hindsight, over a reasonable period of time, with your foresight or with the foresight of your investment counsel. This will probably cure you, as it did me, of hindsight trouble.

Very sincerely yours,
H. G. CARPENTER

Letter No. 24 . . .

AN ESTATE PLANNING PROBLEM

DEAR MR. SMITH:

We are in receipt of your letter of the sixteenth devoted to the financial situation of your father, who is sixty-five years old, and note your query as to the possibility of rearranging his affairs so as to reduce estate taxes.

Your father's estate planning problem is a very simple one, composed, as his estate is, solely of \$300,000 worth of marketable securities and \$150,000 in life insurance payable to your mother. The cost of transfer to your mother in the event of his death, as his estate now stands, will be approximately \$75,300, made up as follows:

| | |
|--|----------|
| Administration costs (executor's fees, attorney's fees and court costs)..... | \$15,000 |
| Federal estate tax..... | 51,000 |
| New York estate tax..... | 9,300 |
| | <hr/> |
| Total..... | \$75,300 |

Without going into details, two changes, each easy to make (taking his life insurance out of taxation and making a gift of \$50,000), would reduce his estate taxes to approximately \$51,000—a saving of about \$26,000.

We should, however, look farther ahead than the death of your father. He has already, you say, given your mother \$300,000. If he dies first (as it is presumed he will because of his ill health) her worth will then be increased, as his estate now stands, by \$375,000—\$225,000 in securities, after estate

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taxes are paid, and \$150,000 life insurance—making her total worth approximately \$675,000.

When your mother dies, another set of estate taxes will have to be paid approximating \$151,250 (administration costs, \$33,750; Federal estate tax, \$97,000; and New York estate tax, \$20,500). If she dies more than five years after the date of your father's death, *another* set of estate taxes will have to be paid on the money she receives from your father. Thus transfer taxes on your father's estate, if both estates are left in their present form, will approximate \$226,000 before his property reaches you and the other heirs.

Again without going into too much detail, about \$90,000 *more* can be saved by two more relatively easy steps.

1. Your father can create a trust of his securities, giving your mother adequate benefits throughout her life, and
2. He can trustee the insurance either with a trust company or the insurance companies themselves, life benefits going to your mother.

The above rather commonplace suggestions will reduce transfer costs by approximately \$117,000, and there are perhaps additional savings which could be made upon detailed examination of both estates. Also, his estate plan should not be based entirely on the assumption that he will die first. I know of one instance where a father was left penniless because his wife, contrary to all expectations, died first.

Worthwhile reductions in *income taxes* can also sometimes be made by careful estate planning. In your mother's

AN ESTATE PLANNING PROBLEM

case, for instance, her income taxes (Federal and New York State), as the estates are now arranged, after your father's death, will approximate \$4,200 per year. By the creation of several trusts, each taxable to the trustee, her \$4,200 income tax, I believe, can be reduced to about \$2,800.

If you and your father are interested in checking further into this matter of estate planning—and it seems to me you certainly should be, for the amount involved is substantial—please complete the enclosed form which will give us full information regarding his and your mother's affairs, and their desires in the distribution of their estates. We will then prepare a detailed report showing what steps in our opinion can and should be taken. This report is usually divided into the eleven following sections:

1. Analysis
2. Costs of Transfer
3. Liquidation
4. Insurance
5. Real Estate
6. Business Interest
7. Distribution
8. Reduced Costs
9. Management
10. Review
11. Tax Appendix

Upon receipt of our report, and after your study of it, you should then consult your own lawyer, and any action you take should be under his guidance. We have had a great deal

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of experience in the planning of estates, and our examination of so many of them, as well as our co-operation with estate planning organizations, has probably acquainted us with many more of the possible steps to be taken than most lawyers are likely to have encountered. However, the final decision regarding each suggestion rests with you and your lawyer. *We* make the suggestions, *you* decide whether you want to follow them, and *your lawyer* takes the steps necessary to incorporate them in your estate plan.

You asked about fees for estate planning. It is our general policy to afford this service to our clients without charge unless the case is an involved one. What we usually do is to examine each client's case as it is presented to us by questionnaire, such as the one I am enclosing for your father's use. Then we either make our analysis without charge, or tell the client how much our charge will be. In some instances we do all of the work ourselves. In others, the services of estate planning specialists are required. In any event the fee seldom exceeds 1/10 of 1 per cent of the value of the estate. More often it is considerably less.

I want to emphasize again that your father's case is a relatively simple one because he has no business interests or real estate. The more types of interests there are in an estate, and the less liquid it is, the more difficult becomes the task of its planning. In your own case, for instance, while I have little knowledge of your affairs other than investments, I think you might be quite surprised at the number and seriousness of the problems presented were we to imagine you had died last week and put your estate, as it is con-

AN ESTATE PLANNING PROBLEM

stituted at this time, through an hypothetical liquidation. I have seen very few instances of estate plans which could not be improved upon, regardless of the size of the estate.

To give you some idea of the opportunities for improvement, I am listing the thirteen questions from the "Review" section of a 75-page estate planning report. *Each involves a change in the former plans of the estate owner.*

1. Do you wish to file the gift tax returns required for previous gifts, including the real estate put into joint tenancy title with your wife, since June 6, 1932, *on which a gift tax should have been paid?*

(This is a common oversight on the part of improperly advised—or unadvised—estate owners.)

2. Do you wish to make additional gifts for the purpose of reducing your taxable estate?

(Two plans suggested with savings both in distribution costs and in income taxes.)

3. Do you and your wife wish to continue your testamentary trusts throughout the lifetime of your children?

4. Do you wish to give your children a limited, or general, power of appointment, so that they may determine the ultimate distribution of their respective shares?

5. Do you wish to provide that shares of children who do not exercise the power of appointment, or who have no children, shall go to your surviving children and their descendants?

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6. Do you wish to authorize the trustees to encroach upon principal in the event that earned income is insufficient for a beneficiary's support, maintenance, care, education and comfort?
7. Do you wish to remove \$95,000 of your insurance from the U. S. estate tax?

(Two plans suggested.)

8. Do you and your wife wish to convey all of your jointly owned real estate into some other form of ownership in order to avoid additional costs incident to its present status?

(Two plans suggested.)

9. Do you wish to provide that, as each of your sons attains a specified age, he shall become a cotrustee?
10. Do you desire to select the best available management to succeed you in the conduct of your business?
11. Do you want to perpetuate this type of management, and protect it from interference in the future conduct of the business?

(Two methods suggested.)

12. Do you wish to provide that all income shall be credited to principal, and that beneficiaries shall receive a stipulated percentage of the value of such principal?

or

13. Do you wish to provide that your beneficiaries' income shall vary as the cost of living varies?

AN ESTATE PLANNING PROBLEM

(Three plans suggested, with income tax differentials.)

The estate in question had been planned, before we examined it, in a far more able manner than many. The estate owner had an excellent attorney and good advisers in other lines. Nevertheless, after considering all of the facts as set forth in the report, he and his attorney approved every recommendation we had made.

Twelve or thirteen recommendations for changes in an estate plan, or even three or four, may sound rather formidable, as the thought of the estate owner is necessarily led into several unfamiliar channels. But when he visualizes, as he must, that if *he* does not solve these problems, they will have to be met later by his wife and children—when he visualizes *their* perplexities after he has gone, he is apt to conclude that he should shoulder the responsibility himself. Certainly he is more prepared than they to make the decisions required. Furthermore, after his death, it will be too late to effect estate or inheritance tax reductions.

I shall look forward with pleasure to hearing from you at your convenience regarding your father's plans.

Sincerely yours,
H. G. CARPENTER

Letter No. 25 . . .

THE FUND OF AN ELDERLY WIDOW WITH FIXED IDEAS

MY DEAR MRS. SMITH:

After our several letters back and forth regarding the investment fund of your mother, we have come to a conclusion as to how it should be counseled, based upon her circumstances, objectives and preferences as follows:

1. She is, as you have said, a very opinionated person in spite of her seventy years.
2. She has had several rather unfortunate experiences with inferior investment advisers whose efforts to "catch minor swings" have resulted in the material reduction of her fund since your father's death. These experiences have embittered her against any investment plan which contemplates foreseeing economic changes. She is thoroughly convinced that "*no one knows a thing about it,*" and she *will not* change her mind.
3. On the other hand, she has read and studied a great deal and is fully aware of the probability of a material rise in the cost of living during the years ahead. In other words, she realizes the necessity of preserving the purchasing power of her fund by investment, to some extent at least, in earnings-dependent securities.
4. She needs an income of approximately 4 per cent on

THE FUND OF AN ELDERLY WIDOW

the present value of her fund, and she "will not touch one cent of principal."

In view of all of the above, it seems to me that this is one case for which the "median line" method of investment management is well adapted, for the following reasons:

1. The "median line" method assumes, just as your mother so stoutly maintains, that it is impossible for anyone to foretell the direction of the economic trend—whether it will be up or down.
2. It will give her at all times a participation in common stocks, thus affording her a degree of purchasing power preservation.
3. Common stock prices are now¹ at a comparatively low level, and we have noted that the degree of risk involved in this semi-mechanical method is reduced in proportion to the lowness of common stock prices at the time of starting.

It would seem, therefore, that in employing the "median line" method for this somewhat unusual case we can direct the investment of your mother's fund without a great deal of risk, and at the same time conform to her rather peculiar preferences. Our studies of *industries* and the sequence in which they respond to economic developments, as well as our investigations of the relative position of individual companies, should enable us to improve materially upon the results she could attain without our assistance.

You will understand, of course, that we would prefer to

¹ At the time this was written—August 1939.

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counsel this fund via the "major economic trend" method; and we shall be very much surprised as time goes on if the superiority of the results achieved for your fund do not convince your mother that she should change to the "major economic trend" method. However, she has some very strong convictions. We must not forget that it is *her* money and that she should be permitted to exercise her own judgment as to the method employed in its management.

I shall appreciate it very much indeed if you will talk this matter over with your mother at your convenience and let us know her decision.

Very sincerely yours,
H. G. CARPENTER

Letter No. 26 . . .

A TRUST FUND PROBLEM

MY DEAR MR. SMITH:

This will acknowledge receipt of your letter of the thirtieth in which you tell me that you have been informed by an uncle of yours, who is suffering from an incurable malady, that he has named you as cotrustee of his estate. We note that a local trust institution has been designated as trustee and that they will have custody of all securities and other property; but that you, as cotrustee, must, as is usual, approve all of the trustee's actions.

You are quite correct in your assumption that we do not have the facilities for advising you along any line except that of security investment—marketable bonds and stocks. It is quite possible, though, that we may be able to make several suggestions which will make things easier for both you and the trustee after your uncle's death.

Our first recommendation has to do with the subject of the income to be paid to the life beneficiary—the widow. It is the practice of many lawyers to provide that the wife shall receive only the income *earned by the trust*, and that the principal shall be conserved for the children.

Whence came the *conventional*, “*earned-income-only-to-the-wife*” trust form, and how it possibly could have achieved

NOTE: A number of paragraphs in this letter were taken from the author's article in the 1938 Summer issue of the magazine *Law and Contemporary Problems*, a quarterly published by The Duke University School of Law.

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such almost universal usage, is apparently futile to speculate. Probably the first trusts were employed by wealthy testators whose estates were of adequate size to warrant this conventional form—that is, their earnings, even at low rates of interest, were ample to support the life tenant on the scale to which she was accustomed. When, however, this conventional form is employed for estates whose size is so small that earnings of 6 per cent, 5 per cent or even 4 per cent are necessary to maintain the life tenant at her customary scale of living, then indeed does the conventional trust fail. It not only fails to achieve the purpose of the testator with respect to *both life tenant and remaindermen*, but it also involves the trustee in problems of investment management which are practically impossible of solution. It is probably safe to say that much of the unsatisfactory investment management of trusts by trustees, of late years (where there has been unsatisfactory management), has been due in no small measure to this conventional, “*earned-income-only-to-the-wife*” type of trust instrument under which they have been operating.

Let us see how this disservice to beneficiaries and this intensification of the difficulties of investment management to trustees are brought about. There are occasional instances of men whose chief interest and regard, for one reason or another, center in their children and whose concern for their wives is secondary. But these instances are so comparatively rare that for the purpose of these remarks, it safely may be assumed that the prime concern of the average man is for his wife. He wants her, should she survive

A TRUST FUND PROBLEM

him, to live out her days with the same degree of comfort she has enjoyed prior to his death. Let me illustrate the point I want to make by telling you the story of a family I shall call "Jones."

Mr. Jones was a man who had accumulated several hundred thousand dollars. He and his wife had lived comfortably on \$12,000 per year. During the period he had been investing money (from 1910 to 1930) he had been able to secure an average return of 5 per cent. He allowed for all liabilities including death duties and found that, should he die, his net estate would equal or slightly exceed \$200,000. He believed that his wife's living expenses, without him, should be not more than \$10,000, which would be 5 per cent on \$200,000. He wanted to avoid the possibility of duplicate estate taxes when his wife died and he therefore incorporated in his will the conventional trust, providing that his wife should receive the *earned* income (*presumably* 5 per cent) as long as she lived, the principal to pass at her death to his two children. Such an arrangement appeared sound in every respect to Mr. Jones and he died in 1930, happy in the thought that his wife would be supported in comfort through her remaining years and that his two children each would receive \$100,000 when his wife died.

But Mr. Jones, never having died before, failed to contemplate several eventualities, and those with whom he had advised—his lawyer and his trust company—failed to warn him. Interest rates began to decline. Within a few years it developed that the same high grade of security could not be purchased at a yield of 5 per cent. Bonds and mortgages

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which formerly yielded 5 per cent were called and re-issued at 4, or $3\frac{1}{2}$, or even 3 per cent.

Now we come to the breakdown of the conventional, "*earned-income-only-to-the-wife*" type of trust. Let us mark its triple failure:

- (1) in its intensification of difficulties for the trust company,
- (2) in its failure to provide adequate income for the life tenant, and
- (3) in its failure to conserve the capital of the remaindermen.

The trust company Mr. Jones had selected was soon faced with the question of whether it should adhere to high-grade bonds, thus decreasing Mrs. Jones's income, or invest in lower-grade securities in which a greater degree of risk would have to be assumed. It is not at all difficult to imagine the tone of the conference at which the decision was made. Visualize Mr. Brown, Mr. Black and Mr. White of the trust company.

MR. BROWN: "I have called this meeting for the purpose of making a decision on the Peter Jones trust. We must either ask Mrs. Jones to accept a smaller income or we must begin to invest in lower-grade securities. Which shall it be?"

MR. BLACK: "I hate to do either, but certainly it must be one or the other. What do you say, Mr. White?"

MR. WHITE: "Well, I knew Peter Jones better probably than

A TRUST FUND PROBLEM

either of you. I am sure he placed his trust with this bank because he felt we would have a personal interest in his wife. I *know* that Peter first of all wanted his wife taken care of—wanted her to continue to live on the same scale to which she has been accustomed. I hate to cut down on the grade of securities just as much as you two do, but I think we had better try to keep Helen's income at \$10,000. I know Peter would want us to do it that way if he were here. There are a number of issues that are yielding 5 per cent and some of the real estate bonds and mortgages yield 6. Do the best you can, Walter, but keep up her income by all means. These low rates won't last forever and we can switch back into the higher grades when interest rates stiffen a little."

And so it was decided to depart from the high-grade issues—to maintain a 5 per cent income for Mrs. Jones.

But interest rates did not "stiffen a little." They kept getting lower and lower, and as is always the case when an investor seeks 5 per cent in a 3 per cent market, some of those 5 and 6 per cent bonds and mortgages defaulted, while others declined drastically in prospect of default. What had happened to the "Jones" trust is precisely what has happened to thousands of other trusts throughout the country. The trust company and the lawyer knew that Mr. Jones's chief concern, when he set up the trust, was for his wife, yet they permitted him to employ a trust instrument which made it practically impossible for the trust company to carry out his wishes. Results: (1) the trust company had

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a much more difficult task than it might have had; (2) Mrs. Jones's income eventually had to be reduced; (3) the principal of the trust, which was to have been conserved for the children, was materially reduced.

It may be argued that the right kind of a trust company would *not* have reduced the grade of bonds, and that serious losses to the principal of the trust would not, therefore, have occurred. Granting that argument, we are still faced with the fact that Mrs. Jones's income would have had to be reduced, and that is exactly what has happened to a great many "Jones" trusts during the last few years. The principal has been conserved for the children, but "mother" has had her income seriously curtailed—just what Mr. Jones did *not* intend.

Our first suggestion to you therefore, Mr. Smith, is to see that your uncle's trust provides that your aunt's income shall not be limited to the income *earned* by the trust. Living costs may rise, in which event you and the trustee would be in the same predicament as the "Jones" trustee, although for a different reason. The income to be paid to your aunt should be related to *her requirements* instead of being tied up so closely to the earnings of the trust.

There are several ways in which this may be worked out by your uncle, your aunt and their lawyer. One method might be to relate your aunt's income to the cost of living index maintained by the United States Bureau of Labor Statistics, or to some other similar index. The index figure on the date of your uncle's death could be stated as parity, for example, for a \$10,000 payment per annum to your aunt.

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Annually thereafter, on each anniversary of your uncle's death, the payments for the ensuing year could be increased or decreased by the same percentage that the index figure varies from the previous year.

An alternative plan, if your uncle has implicit faith in his wife's judgment and discretion, is to provide that she may, at her own discretion, withdraw as much principal as she needs for her comfort and support. This provision should of course be avoided if there is any possibility that your aunt might be vulnerable to the pleas of the indigent or the designing—relatives or others.

And then there is still another plan, if your uncle sees the investment management handicaps of leaving his wife *only* the *earned* income, but prefers that she be favored or penalized, as the case may be, in the event that the value of the estate appreciates or declines. This sort of trust will provide that your aunt shall receive a stipulated percentage of *the value of the estate* as it is appraised annually on the anniversary of your uncle's death. For example, in the case of the \$200,000 Jones estate, had it been administered in this manner, Mrs. Jones, at 5 per cent, would have received \$10,000 the first year after her husband's death. If the estate appraised at \$210,000 the next year, she would have received \$10,500; but if it declined to \$190,000, she would have received but \$9,500. Thus, instead of being in conflict, as in the conventional trust, the interests of your aunt and her children would be made identical. If the trustee and cotrustee are able to increase the principal of the trust, both your aunt and the children will profit. On the other hand, if the principal of

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the trust declines, both your aunt and the children must suffer.

These various plans should be discussed with your aunt and uncle and their attorney, and *one* of them adopted; for if they do not avoid that "*earned-income-only-to-the-wife*" type of trust, you and the trustee will be in for a very unpleasant experience, I fear.

Our second suggestion pertains to a provision in your uncle's trust which we believe is very necessary. Certainly it is necessary if you are to retain us as your advisers—unless, of course, you want to pay us out of your own pocket. The maximum trustees' fees allowed by law (unless special provision is made in the trust) in our opinion are too low. There is little enough for the trustee, not to mention paying the cotrustee or his investment advisers.

Here is the situation. Your uncle wants you to act as cotrustee and, as such, to approve all acts of the trustee. You employ investment counsel for your own investment fund and obviously, therefore, are reluctant to assume the responsibility for your uncle's wife and children without professional advice. If your uncle wants you to act as cotrustee, therefore, he should make provision in his trust for defraying the expense of the investment advice which you deem necessary.

In Letter No. 18 I referred to our "Quarterly Commentary" service. Rather than bother you to refer to that letter, let me quote below the paragraph on this subject.

"This method cannot properly be termed 'invest-

A TRUST FUND PROBLEM

ment counsel' because so large a part of our regular counsel is left out. The 'quarterly commentary' method is designed primarily for funds which are restricted to 'legal' investments, that is, securities 'legal for trust fund investment.' It is employed largely by trustees of estates or institutions. This service is also occasionally employed by those who are cotrustees with trust companies, and who must therefore approve the management of a trust fund by the corporate trustee. The 'quarterly commentary' service equips the cotrustee with information and statistics which enable him both to make recommendations to the corporate trustee and to pass intelligently upon the corporate trustee's actions."

I trust that the above suggestions will prove of some help to you and that you will communicate with us if you have any further questions.

Very sincerely yours,
H. G. CARPENTER

Letter No. 27 . . .

THE FUND OF A PREOCCUPIED
PROFESSIONAL MAN

DEAR MR. SMITH:

This is to acknowledge the receipt of your letter of the third with reference to the investment fund of your brother, Dr. Holbrook Smith, and we note your remark to the effect that his is "another unusual set of circumstances, objectives and preferences."

No, not so very unusual, Mr. Smith. We have a number of clients like your brother. They are so saturated with the details of their own profession or other specialty that they have developed what amounts to an abhorrence of the details involved in the handling of their own affairs.

We cannot accede to your suggestion that we "act as your brother's agent, take possession of his fund, keep it invested as we see fit and report to him once a year," for one of the self-imposed regulations of the better investment counsel organizations forbids it. There are many concerns calling themselves "investment counsel" who will do it, but I would strongly urge that your brother avoid them, for the reason that the combination of the investment management function with the fiduciary function affords too great an opportunity for unethical practices. An excellent article on investment counsel in the July 1939 issue of the *American Magazine* warned against this dual role and told how unscrupulous advisory organizations used it to their own advantage

A PREOCCUPIED PROFESSIONAL MAN

and to their clients' corresponding *disadvantage*. One trick in an active stock market, according to the article, is to place an order with a broker for a certain stock. If the stock advances in price, the "agent" considers it his own purchase, sells at the higher price, pockets the profit, and says nothing to his client about the transaction. On the other hand, if the stock declines in price, he considers it as a transaction for his client.

I realize that both you and your brother have so much confidence in us that you do not believe you are assuming any risk. But why leave the door open to any such practice? The executive personnel of an organization changes. Junior employees, who must be given more or less authority, come and go. Who can say that, *given the chance*, one of them may not succumb to the temptation? I have heard of occurrences in places where integrity seemingly could not be questioned—occurrences which, except for the combination of management and fiduciary capacities, could be called nothing much less than thievery. Usually it is people like your brother, or some unsuspecting widow or orphan, who suffer, but not always. Most of us in this world are inherently honest. It is absolutely impossible for us to visualize what men, even in high places, will do when they can do it legally. In the minds of such people there is a vast difference between *legal* honesty and *moral* honesty. One protection against people of this kind lies in a separation of the investment advisory function from the fiduciary function. Therefore, although we deeply appreciate the confidence you and your brother have evidenced in us, we must abide by that

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principle of our business which forbids combining our investment advisory capacity with a fiduciary capacity.

This does not mean, however, that your brother cannot be relieved from the details which are so distasteful to him. All over the country there are institutions, chartered by the States or by the Federal Government to act in a fiduciary capacity—trust companies. What your brother should do is to establish a “safekeeping account” with one of these institutions, turning his securities over to them and giving them authority to carry those which are registered—chiefly common stocks—in the name of their “nominee.” This will relieve him even of the necessity of endorsing certificates which may be sold. Customers of the trust company are protected against theft or embezzlement of their securities by blanket bonds which the trust companies carry. The cost of a “safekeeping account” is nominal.

Your brother may then instruct us to send copies of our recommendations for changes in his account to the trust company—the originals going to him. Usually an investor likes to approve the recommendations himself first, and then authorize the trust company to follow them. He can, however, if he so desires, instruct the trust company to follow our recommendations upon their receipt without waiting for instructions from him. By this plan the risk of such machinations as are described in the *American Magazine* article is avoided. The advisory function is effectively separated from the fiduciary function, and your brother will have avoided all *possibility* of loss which *might* be occasioned if he entrusted us with both.

A PREOCCUPIED PROFESSIONAL MAN

I am glad the subject of your brother's account has come up, because I believe the more you think the matter over, the more clearly will you see how dangerous it is to allow several functions to be concentrated in one organization. Suppose, for instance, that in addition to the investment advisory and fiduciary roles, we were also engaged in the sale of securities. Don't you see the temptations we might be confronted with? Suppose we owned some bonds or some mortgages which we knew were beginning to turn "sour." Suppose we owned so many of them that *not* to get rid of them might mean the crippling of our organization. Suppose you or I were the manager of the organization and were responsible to our superiors not only for avoiding losses but for making a profit.

There we would sit: (1) with a lot of souring securities on our hands—successful corporation earnings for the year and perhaps our job in the balance; (2) with the power, as investment adviser, to make recommendations; and (3) with the power, as fiduciary, to follow those recommendations.

What would you do? What would I do?

But what is the use of conjecturing what you or I, or anyone else, would do when the *possibility* of having to make such a decision can be avoided by delegating the several functions to separate, entirely disassociated organizations? That is the concept of investment counsel. Let the investment banker, the broker and the investment dealer offer their securities for sale. Let the investment counsel pass on the

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merits of securities. Let the trust institution perform its fiduciary function.

I hope you will discuss this matter with Dr. Smith as soon as it is convenient. If you and he approve of our suggestions for meeting his requirements, we shall be happy indeed to undertake the counseling of his account.

Very sincerely yours,
H. G. CARPENTER

Letter No. 28 . . .

THE \$25,000 FUND OF A PROSPEROUS
YOUNG BUSINESSMAN

DEAR MR. SMITH:

Your letter of the fifteenth received, inquiring about our facilities for counseling the account of one of your nephews, whose fund you say now amounts to approximately \$25,000. No, indeed, of course you are not imposing upon us. We do not counsel these smaller accounts in exactly the same way that we do the larger ones, but we can and do counsel them through the medium of two "Investment-Counsel-Managed-Funds."

Before I explain what steps your nephew should take, I want to tell you something about my experience with "investment funds"—or, as they are more commonly called, "investment trusts."

My interest in investment trusts dates back to the late twenties, when I began watching their development in this country. There have been many mistakes and some abuses, but I have never for one instant lost my faith in the investment trust *institution*. It is the logical, and as far as I can see, the *only* medium which can supply the need of smaller investors for competent, unbiased investment management. There have been many mistakes and some abuses, as I have said—just as there were in the early days of the English and Scottish trusts; but the past twenty years in this country afford the careful investigator of investment trusts a back-

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ground which should enable him to select the type whose management will give him a high degree of satisfaction.

A FOUR-YEAR TEST—1929-1933

After watching the performance of a number of "trusts" during the late nineteen-twenties, I began, on December 31, 1929, to chart the progress of a number of those in which I was interested. I made a list, alphabetically, of about forty of them, and each month I would record the prices of their shares. At the end of the year I adjusted for dividends by adding the dividends paid during the year, to the year-end price. The difference between that figure and the price at the end of the preceding year showed me the relative performance of the forty trusts.

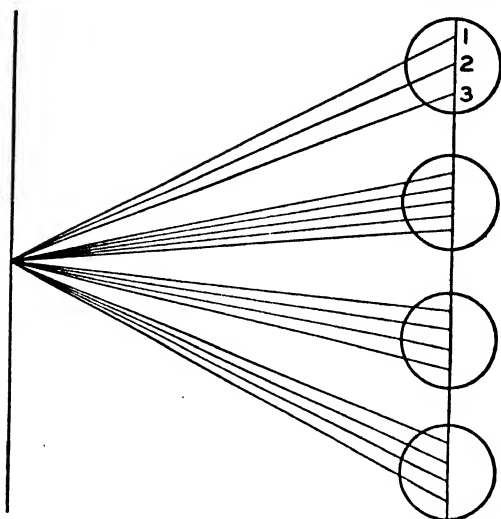
I kept this up during 1930, 1931, 1932 and 1933—two and one-half years of depression and one and one-half years of recovery. Early in 1934, after adjusting for 1933 dividends, it occurred to me to relist the forty investment trusts *in order of their performance* during the four-year period. This I did and was no little surprised to find that the record of results, when reduced to chart form, looked something like the chart on the next page, exaggerated of course.

There were four separate and distinct groups, and I thought right away that each of these groups must have some common characteristic. Looking back now, it seems strange that I did not put my finger on the differentiating factor immediately. However, I did not. I tested those groups many times in all of the "features" investment trust salesmen are

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prone to discuss. Finally it dawned upon me. The only answer there possibly could be was: character of management. I then readily classified the four groups as follows:

1. Those managed by investment bankers
2. Those managed by the investment trust's sales-sponsors
3. Those not managed at all, i.e., fixed trusts
4. Those managed by organizations *whose sole and only business was the professional management of investments.*

To the best of my knowledge there were only three funds

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of the group 4 type in business at that time, *and those three comprised the top group!*

And why not? In selecting investment trusts there is no reason why we should not use the same reasoning employed in selecting competent investment advisers:

1. Are they biased by conflicting interests?

All three of the top group were managed by professional investment managers with no conflicting interests engendered by security selling or other business affiliations.

2. What methods do they employ?

No. 1 and No. 2 of the top group employed the "major economic trend" method, No. 3, the "median line" method.

3. Do they have adequate facilities?

Each of three organizations had adequate facilities for the type of management they conducted.

4. What has been their record during a difficult period?

They were the top three out of a list of forty. The two employing the "major economic trend" method were No. 1 and No. 2. The one employing the "median line" method was No. 3.

Had I started looking for good investment trusts by making inquiry regarding the four points listed above, I would have found those three. Working the other way around—starting with the three trusts and trying to find out why they were successful—I came, inevitably, to the same four

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reasons for their success! It seems to prove itself, doesn't it?

A TEN-YEAR TEST—1929-1939

This method of testing the ability of investment trust managements has recently been adopted by *Barron's*, the financial weekly. In its quarterly table depicting the record of ten mutual funds which have been in business since 1929, the two leaders are the same two which had surpassed all others in my 1929-1933 test—both funds directed by professional investment managers with no conflicting interests engendered by security selling or other business affiliations, i.e., "Investment-Counsel-Managed-Funds."

RELATIVELY INCONSEQUENTIAL DETAILS

One would think that the record of the better investment counsel organizations would impress investors to such a degree that there would be a scramble to buy the shares of investment-counsel-managed-funds directed by such institutions. This has not been the case, however. None of the investment-counsel-managed-funds has been *popular* with the general public. The reason, of course, is the same reason that has caused so many larger investors to err in the selection of their investment advisers. They do not investigate those same four important points:

1. Conflicting interests
2. Methods employed
3. Facilities and organization
4. Results achieved in the past.

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Instead of the above, one hears a great deal of talk about such relatively inconsequential details as the following:

1. Minor differences in operating costs
2. Size of the "entrance fee" or "premium"
3. Success of the sponsors in selling a large volume of shares
4. Size of the fund
5. Age of the fund
6. Price of the shares
7. Current income
8. Wall Street "connections"
9. Short-term record
10. Leverage

and a host of other arguments which seemingly afford a smoke screen to evade discussion of the only truly important consideration—*ability of those who direct the fund to manage investments successfully.*

"ENTRANCE FEE" OR "PREMIUM"

There is always some "spread" between the price you pay when you buy, and the price you receive if you sell securities, even those listed on the stock exchanges. In the distribution of the shares of an investment fund such as the one I am going to suggest for your nephew there is an initial charge, called the "entrance fee" or "premium," for participation in the fund. The premium for an amount as large as \$25,000 is fairly nominal, however, and it is less for \$50,000 or more. This charge need not necessarily be considered by

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the investor as non-recoverable expense. In one of the more competently managed funds whose record I have referred to above, investors paid a premium of 6 per cent. The management of this fund has been so successful that at times the shares command a premium ranging as high as 15 per cent! Thus the investor who paid a premium of 6 per cent to get in could sell his shares at a premium of nearly 15 per cent. The *best part of his investment* was that "entrance fee" or "premium," which in a few years has more than doubled. Competent investment management *should* command a premium, and as the public learns to look for management ability, we should see more of the ably-managed funds selling at a substantial advance over the actual worth of their assets.

TWO INVESTMENT-COUNSEL-MANAGED-FUNDS

One criticism of investment funds in which shares are sold is that each such fund must adopt an investment policy designed for a certain type of investor; and that the individual circumstances, objectives and preferences of each investor participating in the fund cannot be taken into consideration. In order to find a solution for this problem the organization with which I am associated directs the policies of two investment-counsel-managed-funds.

Having in mind that the first responsibility of anyone owning or managing investments is the preservation of principal, these funds may be said to differ in their secondary objectives. One is designed to suit the general requirements

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of an average investor. It may invest within restrictions which, while liberal, do not violate sound investment practice. It may invest up to 100 per cent of its capital either in common stocks, or in bonds, or retain only cash. Usually, however, each of the above types of asset would be held in varying amounts depending upon economic conditions. The objective of this fund could be stated as that of growth and accumulation. The other fund is designed for investors whose circumstances, objectives and preferences demand a more restricted treatment, with emphasis upon income. This fund may invest a maximum of only 60 per cent in common stocks.

With the two investment-counsel-managed-funds it is possible to meet the general requirements of almost any type of investor. The circumstances, objectives and preferences of your nephew, it seems to me, would call for his investment in the fund first referred to above. At the other extreme we might visualize, let us say, a woman whose circumstances are such that her capital should be managed with more emphasis on current income. For her I would advise the other investment-counsel-managed-fund. In between these extremes we might find someone whose circumstances are such that a half-way-between policy would be proper. He could place half of his capital in the one fund, and half in the other. Or we might visualize still other investors who should place three-fourths of their capital in one and one-fourth in the other—or *one-fourth* in one and *three-fourths* in the other. With the *two* funds it is possible to devise pro-

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grams which will meet the requirements of investors of all classes.

Your nephew, if he decides to follow my suggestion, should realize that the funds whose investment policies we direct are neither large nor old, but they will have the same careful unbiased management which we apply to the accounts of our individual investment counsel clients. The same methods are used. The same facilities and organization are available. Equally good results should be achieved.

"Investment-counsel-managed funds" are not distributed very generally by investment dealers, many of whom still judge and sell investment trusts on the "relatively inconsequential details" basis. For example, one investment dealer with whom I talked recently, said that he would sell no trust which had not achieved a size of at least \$10,000,000 and which was not at least ten years old. The trust in which he specialized declined approximately 85 per cent during the 1929-1932 depression and approximately 50 per cent during the 1937-1938 decline, the method employed by its managers being to stay almost completely invested in common stocks *at all times*. From December 31, 1929 to December 31, 1938 this trust *declined* approximately 23 per cent, after credit for dividends paid—during the same period in which the composite record (after credit for dividends paid) of the three investment-counsel-managed-funds, referred to earlier in this letter, *increased* approximately 50 per cent.

I heard another investment dealer bragging to a customer about the *twenty-day* advance of a fund with high leverage! That fund had had one of the poorest investment manage-

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ment records of all investment trusts during the preceding five years, and had declined over 50 per cent since the customer had purchased it—and still the dealer, loyal to the sponsors, was bragging about its record!

Still another dealer insists that the trusts he sells shall be priced under \$5. He says they are easier to sell because the investor gets *more shares* for his money—as though \$1,000 divided into 200 shares could be more successfully invested than \$1,000 divided into 50 shares, or any other number.

“Investment-counsel-managed-funds,” as I said above, are not distributed very generally by investment dealers, but here and there throughout the country will be found an office which has become convinced that it is a wise move to place at least part of their customers’ funds under the direction of competent investment counsel, through the medium of the investment-counsel-managed-fund. Dealers must be very careful, however, in their selection of such funds, because many an investment trust sponsor, sensing the trend toward investment counsel, has turned “investment counsel” overnight. Also, as I have mentioned heretofore, the *title* “investment counsel” means nothing in itself. Claims to investment trust management ability should be investigated for the same four qualifications as I have mentioned so often before:

1. Absence of conflicting interests
2. Methods employed
3. Facilities and organization
4. *Results achieved in the past.*

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In your city James T. Cavanaugh & Co., 118 Spring Street, represents the distributor of the funds we manage. Your nephew can get in touch with that office, or if he lives in some other city, you might suggest that he write direct to me.

Very sincerely yours,

H. G. CARPENTER

Letter No. 29 . . .

THE \$10,000 FUND OF AN UNMARRIED WOMAN

MY DEAR MRS. SMITH:

It is a pleasure to hear from you again, to know that you like the way your account has been getting on, and to receive the information regarding your friend whose investments approximate \$10,000.

I have recently written Mr. Smith a long letter about our means of counseling these smaller accounts. It is possible that he has already let you read that letter, but on the chance that you have not, I am enclosing a copy of it in the envelope with this letter.

Your friend's situation, it seems to me, is one for which our Fund "B" is well adapted. She is of middle age, fifty, and is employed at a fairly good salary from which she is able to save about \$75 per month. She has insurance which will pay her \$100 per month for life after age sixty. Her health is good and the nature of her employment is such that she should be able to continue working until she reaches sixty.

This lady is not going to end her days in an old ladies' home, no matter what happens. Her insurance money will take care of that. But living costs may advance materially before she retires, and the insurance company will pay her only \$100 per month, no matter how far living costs rise. But her insurance program affords no protection against the fluctuation of the purchasing power of her dollars. She can properly assume a minor degree of *dollar* risk in her invest-

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ment account, in an endeavor to preserve purchasing power, should that become necessary. If it does not, a few thousand dollars extra will provide a number of comforts which might not be possible if her sole objective were capital conservation.

It is vitally important for her to conserve her capital—all the more important because she has so little. But there are the two elements in her situation which warrant the holding of a moderate percentage of common stocks. One element is the insurance backlog which warrants her departure from a purely defensive program. The other is the danger of rising living costs. Fund "B," in my opinion, would be an ideal investment for her.

Thank you, indeed, for your inquiry. Should you or your friend require any additional information, please write to me at any time.

Very sincerely yours,
H. G. CARPENTER

Letter No. 30 . . .

THE \$3,000 FUND OF A YOUNG MARRIED COUPLE

MY DEAR MRS. SMITH:

It is with pleasure indeed that I receive your letter of the seventeenth regarding the \$3,000 fund of your niece and nephew. Far from being "bothered," as you suggest in your letter, I am deeply interested in the financial welfare of these smaller investors. It is they who need guidance *even more* than do people of greater wealth, for a loss which would be practically unnoticed in a large fund can seriously cripple the man or woman with only a few thousand or a few hundred dollars.

The small investor, in the eyes of the investment selling world, has been too much like the boy or girl in a candy store with a penny—an unavoidable annoyance who is to be waited on quickly and sold something in which there is as much profit as possible. Frequently, I fear, the small investor, who may know little either about circumstances and objectives, or securities, has bought what seemed to be the biggest piece of candy for his money, with little thought as to its possible effect on his stomach. The story he always has heard has been about the *security*; never about how it would fit in with his other holdings to create an investment program adapted to his own particular circumstances and objectives—and that, it so happens, is a very important part of investment management.

FUND OF A YOUNG MARRIED COUPLE

And this is where the two funds I have mentioned come in. From the information in their "Statement of Circumstances, Objectives and Preferences," I would say that this is an instance where one-half of their \$3,000 should be invested in the first fund discussed in Letter No. 25, and the other half in the other fund. This will give them an investment account balanced in approximately the same proportions that we would employ if they had a \$100,000 or a \$200,000 account. They will be securing a diversification among thirty or forty different securities which would otherwise be impossible for a \$3,000 fund. Their brokerage commissions will be much less. The trouble of collecting a large number of dividend checks will be reduced to eight remittances per year. And all of the time they will be getting the management of the same investment counsel organization that is serving you and Mr. Smith.

Please let me know the decision of your niece and nephew.

Very sincerely yours,

H. G. CARPENTER

Letter No. 31 . . .

INVESTMENT PEACE OF MIND

DEAR FRIENDS:

I do not believe that I have ever received a letter which gave me so much genuine pleasure as yours of the seventh, signed by both of you.

It is a *compliment* when as great a number of letters as I have written to you are read *once* by the recipients. But when you say that you have read them "over and over again," that, indeed, is a *tribute*.

But more than anything else, I appreciate your statement that in your association with this office, you both, for the first time in your lives, have experienced "Investment Peace of Mind." That is a status which is one of the most priceless possessions an investor can have, and I want you to know that your achievement of it has been due fully as much to yourselves as to my efforts or those of other members of our staff. It seems to me that our mutually satisfactory and happy association has been made possible chiefly by your splendidly co-operative attitude which I analyze as follows:

1. You have both been successful investors for many years, and are therefore aware of the great difficulties attending successful investment management.
2. You have both tasted the thrill of attempting perfection in the management of your accounts, and

INVESTMENT PEACE OF MIND

have learned, as all thoughtful investors do, that the experience has been costly.

3. You have been co-operative, rather than challenging, toward our many suggestions for changing both *methods* and *policies*, that they might accord with your respective circumstances, objectives and preferences.
4. You have been sympathetic and encouraging during the difficult periods, and commendatory when things were going well. We were particularly appreciative of Mr. Smith's letter at the troublesome 1937 year-end when he wrote to compliment us on the fact that our composite record had suffered less than a 10 per cent decline from its January 1, 1936 level. He was not disturbed because his account had declined *more* in 1937 than our composite; and Mrs. Smith's, less—recognizing that his was a more aggressive fund than the average; and Mrs. Smith's, more conservative. Again at the end of 1938, he pointed out that our composite record had recovered to a point well above January 1, 1936. You appreciate the significance of the all-important fact that investment management results *must* be reckoned in periods of years, rather than months or quarters.

In short, Mr. and Mrs. Smith, you have been ideal co-operators. There has been a perfect understanding between us. If we have contributed something to your attainment of peace of mind as investors, we are happy indeed, because

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you have contributed a great deal to *our* peace of mind as *investment counsel*. We have enjoyed having you as members of our family of clients, and hope that our association may continue to be a mutually happy and profitable one for many years to come.

We are very pleased, too, to have been of assistance in more closely adapting the accounts of some of your relatives who are smaller investors to their own personal circumstances, objectives and preferences; and to have brought their funds under the guidance of the same counsel that directs your accounts.

Please always let us know when you have any comments or suggestions.

Very sincerely yours,
H. G. CARPENTER

The booklets and questionnaires listed below are available, at no charge, to those interested in the problems of investment management. Address E. W. Axe & Co., Inc., attention H. G. Carpenter, 730 Fifth Avenue, New York. List your selections, if more than one, in the order of your preference.

| | |
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| Investment management questionnaire—helpful in designing an investor's account to fit his circumstances, objectives and preferences | No Charge |
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| FIRST PRINCIPLES OF INVESTMENT, an exposition of the "Long Economic Trend" method of investment management | No Charge |
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| INFLATION AND THE INVESTOR | No Charge |
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| A CONSIDERATION OF THE SELECTION OF ISSUES FOR THE COMMON STOCK ELEMENT OF AN INVESTMENT FUND | No Charge |
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| A SUCCESSFUL INVESTOR'S LETTERS TO HIS SON | Cloth binding | \$1.50 |
| | Paper binding | No Charge |

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| Estate planning questionnaire—covering the most important items to be considered in the planning of an estate so as (1) to effect the greatest savings possible in estate, inheritance and income taxes; and (2) to assure the availability of the assets of the estate for the purposes contemplated by the estate owner | No Charge |
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